

NATIONAL TAX JOURNAL

UNIVERSITY
OF MICHIGAN

DEC 18 1951

BUSINESS ADMINISTRATION
LIBRARY

Volume IV, No. 4

December 1951

Some Recent Developments in Canadian Taxation

The Fifteen Per Cent Tax on Undistributed Income of Companies

F. R. Irwin 289

Deferred Depreciation H. D. McGurran 299

The Purchase Tax and Fiscal Policy Arnold M. Soloway 304

Extractive Industries and the Excess Profits Tax Douglas H. Eldridge 315

A Constant-Purchasing-Power Savings Bond Richard Goode 332

The Farmer's Tax Burden Edward L. Henry 341

Taxation of Intangible Personal Property in Ohio .. George W. Thatcher 351

Inequalities of Residential Property Taxation in Metropolitan Boston

Roswell G. Townsend 361

Fringe Growth and Tax Rates Robert C. Schmitt 370

(Continued inside cover)

PUBLISHED QUARTERLY BY THE NATIONAL TAX ASSOCIATION

NATIONAL TAX JOURNAL

PUBLISHED QUARTERLY BY THE NATIONAL TAX ASSOCIATION

Yearly subscription, \$3.75

(To members included in
annual dues)

Single copy, \$1.21

CONTENTS

(Continued from front cover)

Book Reviews and Notes

Department of Finance, State of Illinois, The Illinois State Budget for the
Biennium July 1, 1951 to June 30, 1953 and Services and Costs: 1950.

Allen D. Manvel 372

Albert G. Hart, Defense without Inflation.

Albert G. Hart and E. Cary Brown, Financing Defense: Federal Tax and Ex-
penditure Policies John Lintner 373

Lyle C. Fitch, Taxing Municipal Bond Income George E. Lent 376

Book Notes 377

NTA Notes 378

EDITOR

J. KEITH BUTTERS

Graduate School of Business Administration, Harvard University

MARJORIE WILLARD, Assistant to the Editor

ASSOCIATE EDITOR

LAWRENCE E. THOMPSON

EDITORIAL ADVISORY BOARD

MICHAEL D. BACHRACH, Certified
Public Accountant, Pittsburgh

ROY BLAKEY, University of Minnesota

WELLES GRAY, Pennsylvania Economy

League, Harrisburg

ARTHUR H. KENT, Attorney, San
Francisco

I. M. LABOVITZ, U. S. Bureau of the
Budget, Washington, D. C.

DIXWELL L. PIERCE, State Board of
Equalization, California

Also Officers of the Association, ex officio

Subscriptions should be sent to the publication office at 111 East Chestnut Street, Lancaster, Pennsylvania, or to Ronald B. Welch, Secretary, National Tax Association, P. O. Box 1799, Sacramento 6, California. Applications for membership, notices of change of address, and correspondence relating to advertising should be addressed to the Secretary. Complaints of nonreceipt of publications cannot be satisfied unless filed with the Secretary within sixty days of publication; thereafter, regular prices will be charged.

Communications for the editor, manuscripts, and books for review should be sent to J. Keith Butters, Editor, NATIONAL TAX JOURNAL, Soldiers Field, Boston 63, Massachusetts.

Opinions expressed in the JOURNAL are not to be construed as those of the National Tax Association unless expressly so stated.

Entered as second-class matter April 29, 1948, at the post office at Lancaster, Pennsylvania, under the Act of March 3, 1879.

Copyright 1951 by National Tax Association

National Tax Journal

Volume IV, No. 4

December 1951

THE FIFTEEN PER CENT TAX ON UNDISTRIBUTED INCOME OF COMPANIES

F. R. IRWIN *

THE ANNOUNCEMENT in the 1951 Canadian Budget that the privilege of capitalizing undistributed income upon payment of a 15 per cent tax would be available to all companies rounds out a unique piece of legislation designed to deal with a taxation problem which has plagued tax collectors and shareholders alike for many years. The problem is that which arises because companies accumulate earnings instead of paying out all surplus in dividends each year. The solution which has been developed in Canada is to allow companies to pay a flat 15 per cent tax on undistributed earnings, thus creating "tax paid undistributed income" which may then be capitalized and, within the limits of company law procedure, distributed to shareholders free of tax in their hands.

This provision, originally limited to private companies when introduced in 1950 and now made available to all companies, is designed not only to take care of the problem of existing accumulations of undistributed income but to

provide a continuing method by which companies can deal with retained earnings. Greeted as a bold and progressive step in the income tax field, it is expected to go a long way toward solving the problem arising from the heavy individual income tax liability attached to undistributed earnings of companies and the serious double impact of succession duties and income taxes upon the death of a principal shareholder in closely held companies.

The question of what to do about undistributed earnings of companies arose almost as soon as the income tax was introduced in Canada but the problems have been intensified in recent years with the introduction of Dominion succession duties and higher rates of individual income tax. Basically the problem arises because corporate earnings, after being taxed in the hands of the company, are also taxable income when distributed to the shareholders. This principle of so-called "double taxation" has been firmly established in Canadian tax law since 1924 when corporate dividends ceased to be exempt for purposes of normal individual income tax. Although a step was taken

* The author is a member of the Taxation Division of the Department of Finance in Ottawa, Canada.

in Canada in 1949 to reduce this double taxation by the introduction of a tax credit for individuals equal to 10 per cent of net dividend income, this does not go far enough to deal with the problem of accumulated undistributed corporate earnings. It has been a traditional practice for companies to plow profits back into the business, and closely held companies have always accumulated earnings either as a necessary or convenient method of securing new capital, or because the shareholders were reluctant to expose themselves to high rates of individual income tax upon the earnings, or on account of a combination of these factors. However, neither the shareholder of a closely held company nor the tax collector could ever afford to forget that corporate earnings had not completed their course through the taxation mill until they finally passed to the shareholders.

This potential tax liability of earnings retained by a company has exerted an important influence on tax legislation from the early days of income tax. The fact that undistributed earnings of a company attracted individual income tax when paid out as dividends very early created an incentive to devise means of withdrawing these earnings in a form in which they would not be classed as taxable income, and the years since the introduction of an income tax in Canada in 1917 have witnessed a continuing duel between the drafters of tax law and those who strive to minimize their tax through devices available under prevailing legislation. The fact that the Canadian tax system, unlike that in the United States, follows a principle of taxing only income from capital and not accretions to capital itself has added greatly to the attractions

of withdrawing accumulations of income under the guise of capital.

To ensure that all income of a company becomes taxable income in the hands of the shareholders upon distribution it has been necessary to place provisions in the law deeming a dividend to have been received by the shareholders upon certain actions of a company which has undistributed income on hand. These provisions have varied from time to time but at present the most important requires that a dividend shall be deemed to have been received by a shareholder equal to his portion of the undistributed income on hand (or the value of the distribution if lesser) when funds or property of a company having undistributed income on hand are distributed or appropriated in any manner for the benefit of shareholders on the winding up, discontinuance, or reorganization of the business. A similar provision applies where a company having undistributed income on hand redeems or acquires any of its common shares, reduces its common stock, or converts any of its common shares into another type of shares or obligations. It is further provided that when a company capitalizes any part of its undistributed income on hand a dividend shall be deemed to have been received by each shareholder equal to his portion of the undistributed income that was capitalized.

In addition, there are a number of provisions designed to prevent the distribution of earnings in any form which would escape tax. These operate whether or not there is undistributed income on hand and cover a premium paid on the redemption or acquisition of shares and the lending of money by a company to its shareholders.

The only corporate earnings which enjoy any form of immunity are profits earned before the income tax was introduced in 1917. These have not been made subject to tax when distributed upon reorganization or winding up of the company. Since 1921, however, all profits of a company, no matter when earned, have been taxable income when distributed as ordinary dividends.

It is interesting to note that the efforts of the lawmakers have been largely directed to framing measures designed to guard against the withdrawal of corporate earnings in a form other than regular dividends and that little serious attempt has been made to deal with unwarranted accumulations of earnings. Canada, for example, has never levied a tax directly upon undistributed income of corporations along the lines found in a number of other countries, although there was for many years a provision in the law similar to section 102 of the *Internal Revenue Code* of the United States. This provision said that if the tax authorities were of the opinion that the accumulation of profits was in excess of what was reasonably required for the purpose of the business, they could notify the company by registered letter of the amount which they considered excessive, and if that amount was not distributed it was deemed to have been received by the shareholders. This so-called "big stick provision" was little more than a threat until 1949 when the tax collecting department began to apply the section in a number of cases. Immediate and widespread objections were raised to its use, based largely upon the grounds that the judgment of company officials as to what was required in the business was

being superseded by the arbitrary opinion of the tax officials. The section was repealed in 1950 with the introduction of the new provisions dealing with undistributed income.

These efforts of the tax collector to ensure that every dollar of corporate earnings bears its full share of individual income tax have in the past brought hardship in some cases and questionable benefits to the economy as a whole. The hardship became especially apparent in the case of small, closely held businesses. In an expanding free enterprise economy many companies begin as small family businesses or from the combined efforts of a few individuals. These start out with small amounts of capital but by turning back into the undertaking a large part of the profits each year they are able to expand. This means the gradual accumulation of an undistributed surplus but this surplus is usually in the form of buildings, machinery, and inventory, or is otherwise used in the conduct of the business. As these businesses prospered in the past the problem presented by their undistributed earnings increased. If the principal shareholders wished to withdraw all or a part of the earnings from the company a large part of the lump sum distribution would inevitably be eaten up by the individual income tax it attracted when received by the shareholders. Under progressive rates of individual income tax a much larger portion of a lump sum distribution is taken in tax than would be the case had the income been distributed regularly over the years.

When a principal shareholder in a closely held company died a serious situation often arose. The value of his holdings in the company as part of his

estate became subject to succession duties. In many instances the principal asset of the deceased was his equity in the company and in order to pay succession duties it became necessary to distribute a large part of the accumulated earnings as a dividend. The dividend became liable for individual income tax at graduated rates and only the remainder after tax was available to pay succession duties. As a result very large distributions might be required, placing a severe strain upon the business where the accumulated earnings were invested in physical goods. The combined impact of income tax and federal and provincial succession duties sometimes resulted in the confiscation of almost the entire estate.

Frequently the only course was to sell the business but this was often a difficult problem. Sales made under such circumstances placed the sellers at a disadvantage and the price was likely to be below the true value of the business as a going concern. The most likely purchasers were competitors or large companies wishing to extend their control over an industry. Sometimes such a sale resulted in the closing down of a business with serious consequences for a small community.

Apart from the matter of succession duties, the shareholders of small, closely held companies have obviously been at a disadvantage compared with the shareholders of widely held public companies. In the latter case the value of the shares increases as the company invests its undistributed earnings in new plant. If such shares are sold at an increase in price which reflects these new assets and increased earning power the shareholder receives the equivalent of

his portion of the undistributed earnings in the form of a tax-free capital gain.

Considering the vexatious potentialities of the tax liability attached to undistributed corporate earnings it is not surprising that attempts were made to deal with this problem before 1950. The first try at a solution was made in 1930 when an amendment was passed which had the effect of permitting the distribution free of tax of all earnings accumulated up to the end of the 1929 taxation year on winding up, discontinuance, or reorganization of the company. This provision was withdrawn after four years, presumably because it was thought to be too generous. Despite the beneficial nature of the legislation many companies did not avail themselves of this opportunity. This may have been because of a failure to appreciate fully the advantages offered by the provision or because of the depressed position of many companies in the thirties. In any case the problem was bound to arise again because no provision was made for earnings accumulated after 1929.

The increasing accumulation of company surpluses together with the entry of the Dominion Government into the field of succession duties in 1941, and the greatly increased rates of individual income tax during the war years made the situation acute for many closely held companies. In 1944 a Royal Commission was set up to investigate and report on the tax position of individuals owning a substantial portion of the shares of a private or closely held company which had accumulated undistributed surplus. Following the report of

this commission in 1945 relieving legislation was passed as Part XVIII of the Income War Tax Act.

This legislation provided that private companies (having no more than 75 shareholders) might capitalize and distribute free of tax in the hands of the shareholders all earnings accumulated between 1917 and the end of the 1939 taxation year upon payment of a tax upon the accumulated earnings at rates ranging from 15 per cent to 33 per cent. The rates of tax which varied according to the amounts attributable to each shareholder as at December 31, 1944, were intended to approximate roughly the individual income tax which would have been paid by the shareholders had the surplus been distributed year by year as earned. A company had to elect before December 31, 1947, to pay such tax. When it had so elected and paid the tax, the accumulated earnings could then be distributed as tax-free dividends to the shareholders at any time.

This provision was regarded as a fair and reasonable way to provide an opportunity for private companies to deal with their earnings accumulated up to 1939, and a large number of companies elected to pay the tax and distribute their earnings. A further recommendation of the commission to deal with earnings accumulated after 1939 was regarded as too drastic by the government and not accepted.

Because no provision was made for post-1939 earnings the problem soon arose again. In the period between 1939 and 1949 many companies had accumulated large amounts of undistributed surplus. Also there were a number of companies that had not taken

advantage of the opportunities afforded by the Part XVIII provisions to deal with their pre-1939 undistributed surpluses. Shareholders of closely held companies finding themselves facing heavy income taxes upon any ordinary withdrawal of accumulated earnings, and fearing the impact of succession duties and income tax upon their estate at death, were stimulated to take action which would make available at least some part of their undistributed profits. More and more, closely held companies were sold or driven to a variety of extremely complicated and cumbersome devices to secure legal avoidance of the tax burden to which their shareholders were potentially liable. As a result, a good deal of revenue to which the public treasury had a justifiable claim was being lost.

Reference has already been made to the limited attempt on the part of the tax collecting authorities in 1949 to force a distribution of excessive accumulation of earnings but this line of approach, unpopular with taxpayer and tax collector alike, was never regarded as a solution to the problem. Attempts to match complicated evasion devices with complex legal blocks might have helped for a time but clearly a deeper acting medication was required to clear up the unhealthy state of this segment of the tax structure.

This action was taken in March, 1950, when the Minister of Finance in his Budget speech announced a new plan to deal with surplus earnings of closely held companies. This plan not only provided for earnings accumulated up to the end of 1949 but it also looked to the future and tried to avoid the

shortcomings of previous plans by offering a method of dealing with earnings after 1949. The law which enacted these proposals may therefore be considered as falling into two parts, the first dealing with earnings accumulated up to the end of 1949 and the second part providing for the future.

The first part provided that a private company may elect to be assessed and pay a tax of 15 per cent on an amount equal to its undistributed income on hand at the end of its 1949 taxation year less any amount upon which tax was paid under Part XVIII of the Income War Tax Act but which has not been distributed to shareholders. The definition of "undistributed income on hand" which is necessary in this legislation was along the lines used in Part XVIII of the Income War Tax Act, and, in general, includes all earnings since 1917 less dividends and taxes paid during the period. Losses incurred during the period, as well as expenses and disbursements made by the company but disallowed in computing income for tax purposes, are deductible, and also amounts by which losses on capital exceed gains on capital. A "private company" was defined to mean a corporation with no more than 75 shareholders, not including employees or former employees. A corporation controlled by another corporation through ownership of more than 50 per cent of the issued share capital was also defined as a private company regardless of the number of shareholders if the control was acquired after May 10, 1950.¹

¹ This extension of the definition of "private company" was necessary because of a blocking provision applying to controlled companies, referred to later in the text. This provision was introduced on May 10, 1950, and became effective on that date.

If a company elects and pays the 15 per cent tax on its undistributed income on hand, this undistributed income remaining after payment of the tax (plus the amount, if any, which has borne tax under Part XVIII of the Income War Tax Act, and has not been distributed) becomes "tax paid undistributed income."

There is no time limit within which a company must make this election but the election must deal with all its undistributed earnings accumulated to the end of its 1949 tax year. Having taken this action, it is then in a position to avail itself of the second part of the legislation designed to provide a continuing remedy for the problem of earnings accumulated after 1949. This part of the legislation permits a company to elect to pay a 15 per cent tax upon an amount of its earnings accumulated after 1949 equal to the amount of its earnings which has been distributed in dividends during the period. This election may be made each year or after any number of years to deal with the accumulated earnings from the end of 1949 to that time, but this second step cannot be taken until a company has paid the 15 per cent tax on its undistributed income on hand at the end of its 1949 taxation year. The amount upon which the 15 per cent tax has been paid, less the 15 per cent tax actually paid, becomes "tax paid undistributed income."

Unlike the procedure which existed in the case of the earlier solution offered under Part XVIII of the Income War Tax Act, this tax paid undistributed income does not constitute a fund from which cash dividends, tax-free in the hands of the shareholders, may be paid. A way has been cleared, however, for

distribution of these funds to shareholders in such a manner that they will not be taxable in their hands. To do this, the old legal blocks that deemed a dividend to have been paid when a company does any of a number of things which would mean a distribution of its undistributed income to shareholders, have been left in the law, but a provision has been added to make nontaxable that portion of such a "deemed-to-be-dividend" which is the same as the shareholder's portion of the paying company's tax paid undistributed income. In addition, the law was changed so that a stock dividend is no longer classed as a dividend.

In practice, this means that a company which has acquired tax paid undistributed income may capitalize it and then distribute this capital in any convenient way within the general provisions of company law. The most popular method is to capitalize all, or a part of the tax paid undistributed income, and issue redeemable preference shares to represent this increased capital. These preferred shares may then be redeemed at any time and the money received on redemption is not taxable income of the shareholder.

Since tax paid undistributed income may be distributed quite legally in a form in which it is not taxable income of the shareholder, it may be asked why companies were put to the trouble of a complicated procedure and not allowed to make a distribution in the form of tax-free cash dividends. One reason was the administrative problem of earmarking tax-free dividends. A company may not wish to elect to pay the 15 per cent tax, or having elected, may not wish to make a distribution for many years and it would be very

troublesome to have to police all company dividends in the future to determine the tax-free portion. Another reason stems from the fact that individual taxpayers in Canada may credit against their income tax otherwise payable an amount equal to 10 per cent of their net dividend income from Canadian taxpaying companies. This tax credit is not available in the case of distributions from tax paid undistributed income and it is therefore desirable to keep this form of company distribution separate from ordinary dividends. On the whole the government considered it preferable not to disturb the general income tax law which holds that dividends of a company are income and taxable regardless of source.

Another question which arises is the determination of the rate of 15 per cent. This rate is more favorable than that which was offered under the provisions of Part XVIII of the Income War Tax Act and, unlike this earlier legislation, it does not vary to take account of the amount attributable to each shareholder. However, rates of individual income tax are now lower than during the recent years of accumulation and a flat rate has great advantage on the grounds of simplicity. For the plan to be effective the rate had to be sufficiently attractive to companies to overcome the inducement to resort to complicated deals which meant some loss to the shareholders and no revenue whatsoever to the treasury. The rate of 15 per cent was the same as that levied on the first \$1,000 of individual taxable income at that time and thus represented the lowest rate the corporate earnings would bear if distributed to shareholders who are also taxpayers. But there is an offsetting

feature in the fact that earnings which have borne the 15 per cent tax in the hands of the company do not give rise to the 10 per cent tax credit in the hands of the shareholder which would be available if the earnings had been distributed as ordinary cash dividends. The choice of the rate of 15 per cent was one which apparently seemed to the government to be a reasonable compromise of all these factors.

Although the success of the new plan depended to a large extent upon its being regarded as attractive and reasonable, its position was strengthened by a further blocking provision added at the same time. This additional legislation was designed to prevent the distribution of accumulated earnings in a form which would escape individual income tax through the device of inter-company dividends where one company became controlled by another. Generally a Canadian company in computing its taxable income may deduct all dividends received from another Canadian company, but this new blocking provision made dividends paid by a controlled subsidiary, where control was acquired after May 10, 1950, taxable in the hands of the receiving parent company if the dividends were paid from undistributed earnings on hand when control was acquired which had not borne the new 15 per cent tax. As a corollary to this blocking provision it was necessary to provide by definition that any company controlled by another, where control was acquired after May 10, 1950, was a private company and thus eligible to pay the 15 per cent tax on undistributed earnings.

This extension of the definition of a private company provided a way for companies which had more than 75

shareholders to place themselves in a position in which they could elect to deal with their undistributed income. If more than 50 per cent of the shares of a public company were sufficiently closely held so that they could be transferred to a company newly created after May 10, 1950, for this purpose, the public company was made a controlled company and in this way became a private company by definition. This secondary effect of what was primarily a blocking provision afforded a means whereby the legislation introduced to be applicable to private companies was extended in a limited way to public companies.

The question of making the privilege of paying the 15 per cent tax apply to all companies was considered from the very first and when introducing the legislation in 1950 the Minister of Finance stated that in logic there was no reason why it should not be so extended but he wished to proceed slowly and see how it worked for a year. It soon became apparent that some shareholders of companies, other than private companies, also faced succession duty problems if they held a large proportion of the shares of a company which had sizable amounts of undistributed income on hand. Although a number of these public companies with a concentrated ownership of a majority of the shares became private companies through setting up a controlling company, this device seemed unnecessarily cumbersome. Moreover, a year's watching and waiting had not brought to light any reason why the provision could not be satisfactorily extended and accordingly the Minister of Finance proposed in his Budget speech on April 10 of this year that the provisions for

paying the 15 per cent tax on undistributed earnings be made available to all companies after that date.

It is not expected that the privilege of paying the 15 per cent tax will be used by the majority of public companies where the shares are widely held. In such cases there is no incentive to pay an additional tax on all the earnings accumulated up to the end of 1949 because this accumulation may never be distributed and until a company has taken this first step it cannot deal with earnings after 1949. Moreover, the privilege of paying the 15 per cent tax on the eligible portion of earnings accumulated after 1949 so that these may be capitalized and distributed free of tax will not likely be of advantage to a company whose shares are widely held, especially if many shareholders have only modest incomes. For example, a married taxpayer with a total income of less than \$6,000, which comes mostly from sources other than investment, would be better off to receive all his share of the company's distribution as an ordinary cash dividend because he may then take the 10 per cent tax credit.

The extension of the legislation to include all companies, however, removes the illogical situation that some companies should be excluded merely because they fall on the wrong side of an arbitrary dividing line. In addition to the companies with just over 75 shareholders, and those where one or two shareholders have large holdings, there may be companies that want to capitalize a large earned surplus shown on their balance sheet without any thought of distributing this accumulation. Such

companies may welcome the opportunity to do so through paying the 15 per cent tax, as this will free their shareholders from the liability for individual income tax which this action would otherwise bring about. In all cases, companies are now left free to make the decision based on business circumstances instead of some being denied the right through an arbitrary rule of law. To the extent that the 15 per cent tax is paid on surplus which would not otherwise be distributed it brings revenue to the treasury that would not otherwise be received.

The privilege of dealing with post-1949 earnings through paying the 15 per cent tax is not likely to become an important tax reduction device as can be illustrated by an example. If a company has \$100 profits about 50 per cent is taken in Dominion and provincial corporation income taxes. To take full advantage of the 15 per cent tax provision \$25 of the remainder must be paid in ordinary cash dividends. A 15 per cent tax is paid on the remaining \$25 leaving only \$21.25 to be capitalized and distributed to shareholders. Instead of reducing tax revenue it is possible that this dollar for dollar matching feature may actually stimulate dividend payments, thus increasing individual taxable incomes.

At the same time that Parliament took the important step of broadening this legislation to include all companies, it also acted to limit its application for one particular class of company. This restrictive measure was the withdrawal of the privilege of paying the 15 per cent tax on post-1949 earnings in the case of subsidiary controlled companies.

This step was necessary because it became apparent that a subsidiary controlled company could circumvent the purpose of the requirement that post-1949 income made subject to the 15 per cent tax and capitalized must be matched dollar for dollar with cash dividends. If the subsidiary company were wholly owned, for example, it could pay half its earnings available for distribution to its parent (where as an intercompany dividend it would be tax-free) and pay the 15 per cent tax on the other half. The parent company could in turn become controlled by another company to which it would distribute half this income and pay 15 per cent on the remainder. In this way through a series of controlling companies most of the earnings available for distribution could be turned into tax paid undistributed income and bear a tax of only 15 per cent instead of one-half being distributed to individuals as ordinary dividends.

This restrictive provision which applies to all controlled subsidiary companies no matter when control was acquired, does not affect the right of these companies to pay the 15 per cent tax on their earnings accumulated up to the end of 1949.

All the provisions dealing with the 15 per cent tax on undistributed earnings have been drafted to give as much flexibility in their use as possible. Companies are not obliged to move at once to take advantage of the opportunity to pay the 15 per cent tax because no time limit has been set. As the legislation is written in terms of what the company itself may do, the election to deal with

accumulated earnings may be made after the death of the principal shareholder and still serve to mitigate the double impact of income tax and succession duties. Companies which have paid the tax and capitalized accumulated earnings through an issue of preferred shares need not redeem the shares immediately. This step may be deferred until adequate cash resources are available or until the need for a withdrawal of earnings arises.

It is much too early to appraise fully the results of this innovative legislation. It has been well received by interested shareholders and writers on tax matters in Canada and substantial use has already been made of its provisions. In the period from its introduction until the end of March, 1951, the tax was paid on more than \$606 million of undistributed earnings, resulting in revenue of over \$91 million. This accounted for more than 11 per cent of the total Dominion revenue from corporation taxes received during the fiscal year. Very little of this \$91 million in tax revenue would have been received in 1950-1951 and much of it might never have been received except for this provision. The revenue producing feature will not be so important from now on but it is expected that these provisions to deal with accumulated earnings will alleviate the income tax and succession duty problem of principal shareholders in the years ahead, and provide a means of reconciling the benefits accruing from the retention of earnings by closely held companies with the justifiable tax claims of the treasury.

DEFERRED DEPRECIATION

H. D. MCGURRAN *

LIKE the United States, Canada has long recognized the significance of increasing the rates of capital cost write-offs, more popularly known as depreciation, as a means of encouraging capital expenditures. In February, 1951, Canada announced a proposal to allow accelerated write-offs for certain assets used in defence production. The plan applies to property acquired for defense production for which the Minister of Defence Production has issued a certificate of eligibility.

Having acted to encourage defence production Canada has now introduced a measure to utilize the write-off instrument for a diametric purpose, namely, to discourage certain kinds of capital expenditure. The measure provides that depreciation will be deferred for a period of four years on assets acquired after April 10, 1951, excepting certain classes of assets and certain additional kinds of assets when certified as eligible by the Minister of Trade and Commerce.

The Minister of Finance, in the course of the Budget speech on April 10, 1951, while reviewing recent economic developments in Canada, stated that one of the principal inflationary factors is the pressure generated by the domestic capital boom and indications

were that the pressure would continue to build up in 1951. In fact a survey of capital expenditure plans indicated that capital expenditures which have been increasing steadily since 1946 would be even greater in 1951 than in 1950. Therefore, in attacking the inflation problem it was imperative that some action be taken to curtail the predicted trend of capital expansion.

Recently the banks have tightened the credit reins and interest rates have been increased but many businesses have such substantial amounts of working capital that the monetary policies of banking and financial institutions will have no effect on their expansion plans. It is true that increased corporation income taxes will take a larger share of profits leaving a smaller proportion available for expansion. But many corporations are in the position of being able to finance large projects out of previously earned profits. The increased taxes will not be particularly effective in causing these businesses to forego plans for capital additions. Steel controls will undoubtedly restrict certain kinds of construction, as will shortages of some materials, but some kinds of investment will not be halted by these difficulties. Furthermore, construction controls had been in effect during World War II and had not been as effective as might have been expected.

* The author is a member of the Taxation Division of the Department of Finance in Ottawa, Canada.

"What we need," stated the Minister of Finance, "is a stiff financial deterrent that will affect particularly the businessman who is considering the kind of investment which is attractive not because of its long term soundness, but because it can be written off out of the expected high profits of the next few years at a time when he expects the rate of corporation income tax to be abnormally high."

This deterrent could have taken the form of a measure that would disallow depreciation on any asset acquired after a specified date unless the asset was certified by governmental authority as essential to the productive capacity of the economy. Such a procedure involving scrutiny of all investment projects would, of course, have resulted in distressing delays to the taxpayer and insurmountable difficulties for the administration. A system whereby depreciation would be automatically allowed or disallowed on certain assets and would be allowed on some others after governmental approval seemed to be what was required.

Accordingly, as a means of providing the deterrent, it was proposed to defer for a four-year period the right to deduct depreciation on all assets acquired after April 10, 1951, excepting certain classes of assets defined in the regulations and certain additional kinds of assets when certified as eligible by the Minister of Trade and Commerce. Depreciation on assets acquired by the taxpayer prior to April 11, 1951, will not come within the purview of the measure.

The proposal neither cancels nor diminishes the right to charge depreciation but simply postpones the write-

off for a four-year period—the taxation year in which the property is acquired and three subsequent taxation years. To illustrate, if a taxpayer whose taxation year ends on December 31 acquires an asset on June 1, 1951, he will not be permitted to charge depreciation in the 1951, 1952, 1953, and 1954 taxation years. In the 1955 taxation year the asset can be transferred to the depreciable asset account at its original cost and written off at the normal rates of depreciation. If the asset is acquired, say, in 1952, no depreciation can be charged until 1956.

The existing depreciation regulations contain 15 classes of depreciable assets. Assets coming within seven specified classes will be depreciable in the normal manner even though acquired after April 10, 1951. The seven classes include: (1) bridges, canals, culverts, dams, etc.; (2) such properties as pipe lines and certain other plant connected with the production or distribution of electrical energy, gas, and water; (3) properties of a railway system, a telegraph or telephone system, and a tramway or trolley bus system; (4) radar equipment and radio transmission equipment; (5) such properties as automotive equipment, gas or oil well equipment, mining machinery and equipment; (6) certain articles that can be depreciated entirely in one year, e.g., cutlery, linen, uniforms; and (7) certain patents, franchises, concessions, and licenses.

Property falling into any of these seven classes can be depreciated in the normal way and an eligibility certificate will not be required. There will be no deferment of depreciation in respect of

property acquired by individual farmers, fishermen and professional men. Residential properties (house and apartment blocks) will also be depreciable without eligibility certification as will properties replacing those that have been destroyed by fire, flood, etc.

In addition to the foregoing, a property acquired by a bequest or inheritance, or a property acquired by a taxpayer from a vendor with whom he was not dealing at arm's length if the property was depreciable property of the vendor on April 10, 1951, will be depreciable without certification. The latter class will cover property involved in such transactions as incorporations of partnerships and sole proprietorships.

The Minister of Trade and Commerce, in describing his function in certifying the assets which would be eligible for depreciation, described the underlying principles of this provision. "The Government," said the Minister of Trade and Commerce, "does not wish to discourage in any way capital expenditures which will enable Canadian industry to build up its productive facilities to meet Canada's defence needs. Moreover, in some cases the investment may have a use limited to the defence period, and it would be inequitable to defer capital cost allowances for four years."

Properties for which eligibility certificates may be issued can be divided into three categories: (1) a property acquired by a taxpayer for carrying on certain businesses; (2) a property acquired for the fulfilment of a defence contract or subcontract, or for a purpose which contributed to the defence of Canada; and (3) a property

acquired by a taxpayer who has purchased the business of the vendor.

The industries whose property will come within the orbit of the first group might be described as the basic industries. Included are the primary industries, industries engaged in the processing (including smelting and refining) of raw materials, and enterprises providing a utility service or hospital service. The coverage is qualified, however, by providing that certificates for capital expenditures made by taxpayers in these groups will not be issued if the property is primarily used for hotel or office accommodation, commercial service, finance, wholesale trade, retail trade, or renting for other than residential habitation. To illustrate a potential exclusion, a refining company would undoubtedly be granted a certificate of eligibility for a cracking plant, but would not receive a certificate for a projected retail filling station.

In establishing that property acquired for the fulfilment of a defence contract or subcontract should be eligible, the taxpayer will be required to show that the contract cannot be filled without acquisition of the property in question. Eligibility certificates will only be granted in respect of property acquired for defence purposes in exceptional cases. The intention is to certify property for projects which are vital as a means of supplying some basic material or commodity or of supplying some essential service that does not come within the scope of the preceding paragraph.

The third category did not appear in the deferment measure as it was originally introduced. It was added so that

a taxpayer who purchased the depreciable assets of a business after April 10, 1951, would not have to forego depreciation on those assets. It provides that where a taxpayer acquires a property subsequent to April 10, 1951, in the course of a transaction in which he purchased from a vendor with whom he was dealing at arm's length the vendor's business and all the depreciable property of the vendor that the vendor had been using in his business immediately prior to the transaction, a certificate of eligibility may be issued if the property was depreciable property of the vendor on April 10, 1951.

In attempting to forecast possible effects of the deferment provision it is worth while to examine some of the features of the Canadian system of capital cost allowances which should lend themselves to making the measure effective and which will, at the same time, ensure fairness to the taxpayer. Briefly, the law provides that the taxpayer may deduct such part of the capital cost as is allowed by regulation.

Reference has previously been made to the 15 classes of depreciable assets that are defined in the regulations. The regulations also establish a uniform rate of depreciation for each class. When an asset is acquired the value of that asset is added to the value of the other assets in the same class. The total value of the assets in the class at the year end is the depreciable balance of that class, or "the undepreciated capital cost." The depreciation rate of the class is then applied to the undepreciated capital cost to determine the amount of the deduction for depreciation.

The system recognizes for tax purposes obsolescence and decline in value

as well as physical wear and tear. It guarantees that the taxpayer will recover capital costs of depreciable assets from profits by allowing depreciation whether or not the asset is being used in earning the income from the business.

If there is to be complete amortization of capital costs of depreciable assets it is only logical that the allowances for depreciation should not be excessive. To ensure that excessive depreciation has not been allowed the taxpayer is required to take into account the proceeds of disposal of any depreciable asset. The allowances already deducted are adjusted so that the true net capital cost of the asset is determined.

When a depreciable asset is disposed of and the proceeds are less than the undepreciated capital cost of that asset the difference is added to the undepreciated capital cost of the class and will subsequently be subject to depreciation. If the asset is the only asset in the class the difference is deductible in the year of disposal. A corresponding adjustment is made where the sale price exceeds the undepreciated capital cost and the excess capital cost allowance is recovered.

The foregoing is significant where capital cost allowances are being deferred. If the taxpayer acquires an asset on which depreciation is deferred and sells it at a loss even before the expiration of the four-year period during which he cannot deduct depreciation, the loss will be recoverable. If the asset was the sole asset in the group he will be entitled to deduct the loss in the year of sale even though he would not be deducting depreciation if the asset had not been sold. However, if there are other assets remaining in the class, the

loss will be added to the undepreciated capital cost of the class at the time the asset would have been depreciable if it had been retained.

The second important feature of the Canadian system is that it is based on the diminishing-balance principle and the rates are correspondingly high. Actually the rates are approximately

twice those applicable when the straight line principle was in effect prior to 1949. It is thought that the fact that the substantial part of the capital cost that would normally be recovered in the first four years will not now be recovered until the fifth through the eighth year will be particularly effective in strengthening the deterrent.

THE PURCHASE TAX AND FISCAL POLICY

ARNOLD M. SOLOWAY *

THE CURRENT mobilization program has placed a very heavy responsibility on fiscal policy.¹ Increased tax revenues are being relied on to provide the funds for defense expenditures, and to remove the bulk of the inflationary pressure. Consequently, existing methods of taxation are being re-examined and increased attention is being given to new tax proposals. Because of their anti-inflationary character, renewed interest has been shown in excise, sales, and consumption taxes generally, and the possibilities of a purchase tax, like that developed in Great Britain, have been mentioned with growing frequency.

The Purchase Tax is essentially a comprehensive sales tax which uses different rates for different classes of commodities. In its application, the differential rate structure distinguishes between "necessary" and "luxury" goods not only by type of commodity (e.g., insulin vs. perfume) but it is explicitly recognized that such a distinction must also cut across individual

commodity lines. For example, "utility" clothing² and "utility" furniture satisfy essential needs and are exempt from all tax, but a hand-tailored suit of fine shetland wool or an elaborately constructed divan will be taxed at the same heavy rate as jewelry and other typically luxury goods. Thus, by designing the rate structure to impinge more heavily on goods customarily bought by well-to-do individuals than on the conventional necessities of life, the Purchase Tax, as opposed to customary sales and excise taxes, becomes broadly progressive.

But, progressivity is by no means the only significant feature of the Purchase Tax. Because it can effectively siphon off excess consumer purchasing power, it is admirably adapted to conditions of suppressed inflation. And because its differential rate structure can selectively limit consumption and alter the nation's consumption pattern, it offers a powerful fiscal aid for conserving and directing the flow of resources.

² In Great Britain, "utility" articles are made according to specifications prescribed by the Board of Trade. These specifications are designed "to achieve economy in materials and in the process of manufacture, thereby easing the strain upon labour and factory space." Their price is controlled at all stages. We will have further remarks on this subject in a later section.

* The author is a teaching fellow in the department of economics of Harvard University.

¹ This study was first suggested to me by Prof. J. K. Galbraith, of Harvard University. His guidance and criticism were of inestimable help throughout its preparation.

Origins

The name "Purchase Tax" was first applied by Sir John Simon, then Chancellor of the Exchequer in Great Britain, to a new tax proposed in his Budget Message of April, 1940. The proposed new tax was simply a single rate levy on all goods except essential foods, drinks, and foodstuffs. It differed from a general sales tax primarily in that it was to be paid by retail merchants on the occasion of their purchases of trade goods from wholesalers or manufacturers.

Levying the tax at the wholesale stage rather than upon the final sale to the consumer was preferred for the greater administrative ease in dealing with the much smaller number of wholesalers than retailers. There were some 750,000 established retailers and some 50,000 more street and market traders in Great Britain. Of this 800,000 total, it was estimated that upwards of 300,000 retailers were not in the habit of keeping decipherable inventory and sales records. Thus, the administration of a tax at the retail level would have been far more onerous and expensive than if the tax were levied at the wholesale stage where some 40,000 firms would be involved. It was recognized, however, that retailers would be saddled with higher capital costs due to the addition of the tax burden to inventory charges. Also, if the tax itself was not to exert further inflationary influence, commodity prices could only be allowed to rise by the amount of tax. Thus, consumers would be protected from higher-than-tax price advances.

The wholesale stage was also preferable to any previous stage (e.g., on manufacture, processing, etc.) because

the goods destined for export would thus be automatically exempt from the tax. Levied earlier, the tax would be incorporated, at least partially, in the export price. Because of the British concern for export markets, it was deemed necessary to insure that these goods would not be burdened with the added tax load.

Although it was not admitted, and certainly need not be true, it was also charged at the time that levying the tax at the wholesale stage would prevent consumers from realizing just what the tax burden was on their daily purchases, or on the goods they had to forego for cost reasons. This is a familiar attribute of so-called indirect taxation.

In principle, it would appear to be of relatively little importance whether the tax was levied at the wholesale stage or at the final retail sale. As long as (1) retail markups on account of the tax were restricted by law to the amount of the tax and, (2) the chronic shortage of goods of almost every description resulted in a fairly complete seller's market, the incidence of the tax would be predominantly on the consumers. Differences in economic effects would seemingly be restricted to the consequences of the differential burden placed on the retailers of the taxable goods. In any event, despite the added burden on retailers and the technical difficulties in defining a wholesaler for tax purposes, the tax was levied at the wholesale stage when the Purchase Tax was finally enacted.³

³ In his Budget Message of March, 1941, Sir Kingsley Wood, who succeeded Sir John Simon as Chancellor of the Exchequer, stated that 40,000 traders had registered quickly and the machinery of accounts had worked well in the first year of the tax.

The original Exchequer proposal, which gave a bare outline of the new tax, and sought only "approval in principle" from the House of Commons, encountered strong Parliamentary objections. These objections had a more decisive influence in determining the character of the final law than did the Chancellor's original recommendations. In the form originally contemplated, the Purchase Tax was designed for very comprehensive coverage, specifically including conventional necessities as well as luxuries.⁴ The Exchequer's announced purpose, in those grim, early days of the war, was (1) to "shut down" consumption, and (2) to raise large aggregate revenue via this tax. These apparently contradictory ends, simultaneously to prevent consumption expenditures and to raise large revenues by taxing consumption, were to be achieved by taxing conventional necessities just as heavily as luxuries. The tax was to be "boldly applied"—at a rate not specified but described as "significantly high." In the absence of information from the Exchequer, the rates discussed in Commons ranged from 5 per cent to 15 per cent.

Accordingly, the dominant objections to the proposed tax in the House of Commons were the familiar, but potent, arguments that the tax was regressive and inequitable. It was charged, and with good reason, that the so-called Purchase Tax was merely an

attempt by the Conservative government to impose by indirect means "a disguised Income Tax upon those whom this House would not readily agree to make subject to Income Tax."⁵

As a result of the successful opposition led by Labour members of Commons, the Purchase Tax which was finally enacted in October, 1940, provided: tax exemption for foods and other "essential" items of consumption; a "reduced rate" of $16\frac{2}{3}$ per cent of the wholesale value (approximately equal to 12 per cent of the retail value) on the more necessary kinds of clothing and household goods; and a "basic rate" of $31\frac{1}{3}$ per cent of the wholesale value (approximately equal to 24 per cent of the retail value) on the less essential and luxury goods. Thus, the differential rate, the most important single feature of the Purchase Tax, developed directly out of the demand in Commons for greater equity. And Sir John Simon's original attempt to secure a powerful revenue tax, that by its very regressiveness would also serve to "shut down" mass consumption, was transformed by political necessity into a more modest, progressive-type sales tax.

But, as stated previously, in addition to recognizing the differences in types of goods necessary to low-income consumers (e.g., work shoes) as opposed to those customary for higher-income groups (e.g., jewelry), the Purchase Tax also recognized that the definitions of essential and luxury must cut across individual commodity lines. Without this further distinction, it would have been impossible to develop a commodity tax base wide enough for effective use

⁴ Sir J. Simon clearly stated that "the scheme cannot be limited to luxuries . . . it would not raise the money . . ." and again, "The greater part of civilian demand is for things quite reasonable and shutting down consumer demand cannot simply be shutting down the demand for luxuries. . . ." *H. of C. Debates*, Vol. 360, p. 792.

⁵ *Ibid.*, p. 820, Mr. Silverman.

of the tax. Adherence to the customary tax definitions of luxury and essential goods would have restricted the tax to a very limited number of commodities, most of which were already subject to heavy specific excises. For example, in the original schedule of the Purchase Tax,⁶ "Garments or footwear made wholly or partly of fur skin . . . or silk . . ." were taxed at the basic rate, but the same items made without fur skin or silk were taxed at the reduced rate. And the same items made for children without using fur skin or silk went tax-free, as did several important items of work clothes. Thus, by having the rate structure cut across commodity lines, the new tax was given more comprehensive commodity coverage, and it was made infinitely more practical as an instrument of progressive taxation.

Development

The Purchase Tax which emerged from the Parliamentary debates was very different from the original proposal of the Exchequer. At first sight, it appeared that instead of the major fiscal measure desired by the Treasury, a politically acceptable but ineffective compromise tax had been substituted.⁷ However, by the curious turn of political fate, the very act of emasculating the original proposal as regards its revenue potential⁸ made the Purchase Tax

practicable and effective as a weapon of fiscal control. Once essentials were exempted, and more and less necessary goods differentiated, Commons was willing to allow the use of much higher penal rates on a wide range of commodities in order to help direct the flow of vital resources into war production. The Purchase Tax became the fiscal supplement to direct resource control.

The broad control possibilities of the Purchase Tax, however, did not become evident until it was used by the Treasury in support of the Board of Trade limitations on supplies and resource allocations. In his Budget Message of April, 1942, the new Chancellor of the Exchequer, Sir Kingsley Wood, proposed to increase the rate on a long list of goods from 33 $\frac{1}{3}$ per cent to 66 $\frac{2}{3}$ per cent of their wholesale value. At the same time, he offered exemption from all tax to "utility" clothing to be extended within the year to "utility" furniture, boots, and shoes. He stated: "It is our deliberate intention, on the grounds of the widest national interest, to encourage the production of this clothing for essential needs. . . . This clothing not only gives goods of proper quality at a reasonable price but, not less important, achieves economy in materials and in the process of manufacture, thereby easing the strain upon labour and factory space."⁹ Thus, by discriminatory use of the Purchase Tax, fiscal policy was effectively applied in Britain's wartime drive for greater economy and efficiency in the use of resources. By extending the upper limit of the tax, it could selectively limit consumption; in combination with appropriate exemptions, it could alter the nation's pattern of consumption. So, in

⁶ See United Kingdom *Public General Acts and Measures of 1940*, Finance (No. 2) Act, 1940, Part V, pp. 415-435, and Seventh Schedule, pp. 444-448.

⁷ Sir J. Simon ". . . will destroy the real quality of the tax if exceptions are made at every point . . .", and later, ". . . the double rate limits the effectiveness of the tax . . ." by alleviating the burden on lower income groups. *Ibid.*, pp. 793 and following.

⁸ By extending exemptions and introducing the differential rate.

⁹ *Ibid.*, April 14, 1942.

1943 the rate on many high-bracket commodities was again raised, to 100 per cent of the wholesale value, and the Purchase Tax utilized four different rate schedules.

In the Purchase Tax Act, the Treasury was given authority to shift goods from one tax bracket to another, subject to the approval of Commons. In fact, by generally acquiescing in the successive requests of the Treasury for such changes, and for over-all rate increases, wide discretionary tax powers were allowed by Commons to the government. This flexibility made the tax extremely effective in a rapidly changing situation.

Despite the shift in government from Conservative to Labour Party control since the enactment of the Purchase Tax in 1940, there have been no major changes in the law except in the classification of commodities and the rate structure. In the postwar period the rates were periodically revised to meet the exigencies of Britain's peculiar difficulties. The "inflationary gap," the "dollar shortage," and the new revenue problems resulting from the increased social welfare program all provided a changing background to the function of fiscal policy. As consumer goods production increased and the inflationary pressure permitted, rates on many items were reduced or eliminated. As export needs replaced war production needs, the rates on many other items were raised. Many more household goods were exempted, and for reasons of administrative economy the Treasury resorted almost exclusively to the use of higher rates on commodities already taxed, rather than spreading the tax net over a wider commodity base. Generally, postwar emphasis has been less on

the limitation of consumption and more on revenue yields. Indicative of this pattern were the changes enacted in November, 1947:

Previous Rates (Per cent of wholesale value)	New Rates (Per cent of wholesale value)
16 $\frac{2}{3}$	33 $\frac{1}{3}$
33 $\frac{1}{3}$	50
66 $\frac{2}{3}$	75
100	125

Thus, the biggest proportionate increase in duty was levied on the lowest taxable bracket so that the major burden of the changes fell upon categories of articles which had, presumably, the minimum elasticities of demand. As the *Economist* of November 15, 1947, remarked: "Evidently the changes are designed to produce revenue rather than checking consumption. Although the scope of the tax has not been extended, its centre of gravity is shifted perceptibly nearer to the 'necessary' groups. . . . The increases in the Purchase Tax are admirably adapted to the circumstances of suppressed inflation. . . ." With direct controls still in force, and many goods for domestic consumption still in short supply, the Purchase Tax was revised to drain off more effectively the excess purchasing power in consumer hands. This was not a complete functional change, but rather a change in emphasis to meet the needs of the situation.

Again in 1948, the Purchase Tax was revised on the basis of current needs and experience. In his Budget Message in April of that year, Sir Stafford Cripps, successor to Hugh Dalton as Chancellor of the Exchequer, reviewed the measure in detail. He acknowledged some validity in three specific criticisms of the tax: (1) classifications

were unduly complicated and gave rise to many anomalies; (2) rates pressed too hard on necessities and therefore had an inflationary effect by pricing up living costs; and (3) legal provisions governing the rate of tax were difficult to follow, being scattered among a number of schedules to different Finance Acts. Needing the revenue from the tax, but desirous of lowering prices and providing some relief "for the hard-pressed housewife, who feels the incidence of this tax very keenly," he went on, "I accordingly propose to continue the exemption of all food and fuel, and of utility clothing. . . . Similarly utility furniture, sheets, towels, pillow cases and so on, cups and saucers, saucepans, buckets and so forth, and the various kinds of household brooms, brushes, soap and similar cleaning materials, will all continue to be exempt. One of the great complexities of the present tax is the diversity of rates in force—33⅓ percent., 50 percent., 66⅔ percent., 75 percent., and 125 percent. I propose therefore to reclassify the whole field into four categories—exempt, 33⅓ percent., 66⅔ percent., and 100 percent., all percentages being on the wholesale value." The Purchase Tax provisions of the Revenue Act of 1948¹⁰ have been only slightly changed since then, but it can be expected that Britain's present mobilization program will strongly influence further developments in the structure of the tax.

Effectiveness

As we have seen, the Purchase Tax, since its inception, has played a dual role in the fiscal policy of Great Britain.

¹⁰ See United Kingdom Public General Acts and Measures of 1948, Vol. I, Eighth Schedule, pp. 1116-1130.

It has functioned both as a revenue producer and as an important element in the over-all stabilization strategy. The flexibility inherent in its multiple rate structure has allowed for the shifting emphasis described in the preceding section. Therefore, we cannot use any single criterion in evaluating its effectiveness over the past ten years. Its revenue yields can only be considered in conjunction with its control function.

The War Years. Throughout the war years the revenue from the Purchase Tax was related to the available supplies of consumer goods.¹¹ As Table 1 indicates, the annual yield from the tax was about £100 million from 1941 to 1945; averaging approximately 3.7 per cent of total yearly revenues. But this rather small proportion is not an adequate measure of its real importance

TABLE 1
SELECTED TAX REVENUES 1941-1950*
(Millions of pounds)

Year	Purchase Tax	Personal Income Tax	Total Revenue	Per Cent Purchase Tax of Total Revenue
1941	£ 98	£ 524	£2,074	4.7
1942	110	1,007	2,595	4.2
1943	91.8	1,184	3,039	3.0
1944	100	1,314	3,328	3.2
1945	118	1,361	3,284	3.6
1946	181	1,156	3,341	5.4
1947	246	1,190	3,845	6.4
1948	291	1,367	4,007	7.3
1949	229	1,428	3,924	5.8
1950†	295	1,460	3,896	7.6

* Source: Annual Budget Statements of the Chancellor of the Exchequer.

† Estimate by Exchequer in Budget Statement of April, 1950.

¹¹ "The excess on the Purchase Tax appears to be due mainly to a much slower rate of diminution than was expected in supplies of taxable goods available to the public, coupled in some cases, with a higher level of prices," from Sir Kingsley Wood's Financial Statement on April 12, 1943.

during those war years when the tax was primarily geared to help direct the flow of resources and limit consumption.

Obviously, by using tax rates of the order of $66\frac{2}{3}$ per cent to 100 per cent, consumer goods prices could be so effectively distorted that the market demand for those goods would be severely limited. In this area, the Purchase Tax was without question an extremely effective companion to direct controls. But, by the very nature of the problem, especially for goods below the clearly penal range, it is impossible to obtain a useful quantitative measure. Reductions in the physical volume of purchases were most generally compounded out of several causes. Board of Trade limitations on supply, import restrictions, and physical shortages generally placed an absolute limit on purchases in many fields. The increased cost of living (with other increased taxes as a component) directly influenced shifts in the consumption patterns of different groups. For example, much of the spending power discouraged by the high rates on luxuries, spilled over into demand for increased quantities of utility goods. A housewife may have said: "If I cannot have a fur coat, I can certainly afford another one of cloth." Thus, the attempt to obtain a quantitative measure of the Purchase Tax in inhibiting consumer spending generally would be thwarted by the presence of other variables whose effects cannot be seen.

However, there is acceptable evidence from contemporary observations that in addition to its resource-control function, the Purchase Tax was increasingly effective in limiting consumer spending. A common criticism at the time was

that "the rich continue spending and the poor do without"; and especially after 1942 the high tax rates clearly limited the inflationary pressure from the great mass of consumers. To all but the highest income groups, extended nonessential purchases were practically forbidden, and when they were made the tax siphoned off that much more potential spending power.

Postwar. In the postwar period, as Table 1 shows, receipts from the Purchase Tax have risen in absolute amount, and also as percentage of total revenue. For 1950, its revenue is estimated at £295 million, or 7.6 per cent of estimated total revenue. Although this is certainly a respectable yield from such a considerate tax,¹² it is still only about half the revenue from tobacco, and approximately one-fifth of the total customs and excise receipts. Obviously, the Purchase Tax is still not a monumental revenue-producer; but even judging it only by its yield, as Mr. Dalton was able to say on April 9, 1946: "This tax, in present conditions, not only raises revenue, but also absorbs, or 'mops-up,' as they say in the Treasury, purchasing power, and so helps to prevent inflation."¹³

Just as in the analysis of the war period, however, other criteria cannot be neglected in formulating a judgment. Accordingly, the control functions still vested in the Purchase Tax must also be taken into account. Although its emphasis has been shifted

¹² Considerate in the sense that so very many commodities are now exempt from the tax, and so many more are taxed at the lowest rate. Also, we must remember that rationing and shortages of consumer goods remained as a limit to consumer spending even in the postwar Britain.

¹³ *Budget Message*, April 9, 1946.

more toward revenue, the tax still plays an important role in directing the flow of resources and in limiting the inflationary pressure. The government has been unwilling to revise the tax so as to maximize its revenue yield at the sacrifice of its leverage power in the post-war stabilization program.

Despite frequent objections to anomalies in the tax arising from the arbitrariness which still remains in distinguishing between luxury and necessity, the Purchase Tax is today an important weapon of British fiscal policy.

*Possible Use in the United States*¹⁴

In many respects the United States is now faced with problems similar to those of Great Britain as described above. The antipathy to a general, comprehensive sales tax, levied at any stage of production or sale, is at least as great in this country as it was in Great Britain in 1940. Labor, consumer, and merchant groups have warned that any federal excursion into that area of regressive taxation will be met by the strongest opposition. For that matter, it is obvious that basic political necessity requires the utmost circumspection in any attempt to increase the tax burden on the lower income groups.

At the same time, if the government is to approach a "pay as you go" finance position, and fight the suppressed inflation which is putting increasing pressure on present price and wage controls, it is evident that the spending power of the great mass of incomes in approximately the \$2,000 to

\$6,000 bracket must be taxed much more heavily. We need greatly increased tax revenues and limited consumer spending. Therefore, let us proceed on the assumption that the necessary added taxes will be levied; further, that the "escalator clause," "take-home-pay," and "income parity" arguments will not be allowed to vitiate the entire fiscal program. In other words, assume that the general public will support the national effort and accept a reduction in real income as part of its total burden.

It is, however, axiomatic that the kinds of tax measures used by the government will themselves be an important determinant of the nation's willingness to accept sacrifice over an indefinite period. To the extent that citizens are convinced of the fundamental equity of the distribution of tax burdens, the possibility of maintaining an adequate fiscal policy over the coming years is greatly enhanced. Because the general public accepts the justice of progressive income taxation, and because of its fiscal strength, the Personal Income Tax is the most practicable and politic measure with which to accomplish the bulk of the fiscal job.

If the Personal Income Tax is to make its full contribution to the defense effort, its base must be broadened, higher rates of progression must originate lower in the income scale, and exemptions and deductions must be reduced. But, although the Personal Income Tax provides the best single method for increasing revenue (and absorbing purchasing power) from the lower income groups, as a *single* fiscal measure it is definitely limited. Even assuming the political possibility of making such drastic changes in the rate

¹⁴ The following discussion and conclusion concerning the adaptability of the tax to the United States are primarily exploratory in character. The author is presently working on a study of these problems.

structure as would be necessary if it were to assume the whole of the fiscal burden, the loss of incentive for productive workers, caused by the necessary higher marginal tax rates in the lower brackets, would create a real limit to the possible intensity of its application. Particularly for lower income labor, comparatively devoid of the other inducements and prerogatives common to management and ownership, the decline in monetary reward will be promptly accompanied by a decline from maximum productivity. Drawing from British experience, we note in the *Economist*, of October 27, 1945: "... The Chancellor's main drive has rightly been to raise incentives, and his first step, quite properly, has been to restore the income tax personal allowances to their pre-war . . . level. That is a pure 'incentive' measure, for there is no doubt that the tax deterrent to workers' effort operated most strongly at the income levels that just fell within the tax range. . . ." To the precise degree that monetary incentives are not replaced by patriotic zeal, tax relief will have to be granted if we are to achieve and maintain maximum output. Assuming then, that the Personal Income Tax is adjusted and re-rated, as nearly as can be estimated, to drain income from all classes in amounts safely short of the critical incentives boundary, some supplementary fiscal safeguard to limit the residual inflationary spending power becomes necessary.¹⁵

¹⁵ There is also a large volume of economic income (e.g., imputed rent, payments in kind, consumption of one's own produce, etc.) which for expediency is ignored under the income tax law. Although the Purchase Tax would not remove this discrimination, it would broaden the over-all tax base.

It is largely as a supplement to the Personal Income Tax that the fiscal and control possibilities of the Purchase Tax appear most attractive. By stopping our income tax short of the incentives limit we allow income earners to keep a greater portion of their incremental earnings. They are free to spend on necessities, or to save these earnings, with no further tax penalty. The additional income from extra effort, overtime, etc., is theirs to keep. But once they enter the market for nonessential goods and services, an additional tax will be extracted from them. Allowing income earners to keep the added income, even though additional high taxes are levied on other than necessity purchases, would not have nearly the disastrous effects on incentive that taxing it away in the first instance would produce. The whole incentive for savings and accumulation is not only retained, but it is accentuated.

1. Thus, as part of the over-all stabilization strategy, the Purchase Tax can be an effective supplement to the Personal Income Tax, controlling the margin of inflationary pressure.¹⁶ It can inhibit consumption expenditures and absorb more of the inflationary residue without the danger to incentives which is inherent in pushing personal income tax rates too far.

¹⁶ The margin of inflationary pressure will, of course, vary over time. How much additional consumer purchasing power need be absorbed at any time, will depend on a number of variables, of which the intensity of the defense effort being pursued will be a primary element. To a considerable degree, the pressure from the residual margin of inflationary spending power will vary inversely with the volume of consumer goods production allowed. For a concise statement, see: *Economic Policy in the Present Emergency*, a committee report by J. M. Clark, Chairman, T. W. Schultz, Arthur Smithies, and D. H. Wallace.

2. The multiple rate structure can be designed to help in directing and conserving the flow of vital resources by providing the specific kind of price distortion appropriate to our needs. Despite the exemption of a broad range of essentials from the taxable list, the Purchase Tax would still be a far more comprehensive and systematic means for controlling the use of our resources than the patchwork of excises we now have.

In this connection, as we have seen, the conservation and redirection of resources in Britain through the aid of the Purchase Tax, were in many areas contingent upon its rate structure cutting across individual commodity lines. Without that feature the production of "utility" goods, for example, could not very well have been furthered through the use of taxation. The principle was clearly workable in Great Britain, but, because so many more consumer goods are produced for mass consumption by mass production methods in the United States, it might make the same degree of definition here much more difficult.

As one alternative to establishing utility categories of the same type as are used in Great Britain, however, we could with federal price controls in force over consumer goods, construct our rate pattern on the basis of differential prices for the same type of commodity. For example, we might exempt all men's woolen suits under \$50 in price; tax those between \$50 and \$75 at the minimum, rate A; tax those between \$75 and \$100 at the higher rate B; and all above \$100 at the maximum rate C. In this way, for many different commodities we could approximate the same coercive effect on

resource allocations which would result from the establishment of utility specifications. The degree to which we must carry such efforts for economy in the use of our labor and material resources will depend, finally, on the intensity of the defense mobilization program. If we are pressed to the point of maximum effort we will have little choice but to drive our productive resources into the most essential channels. If, for example, clothing is essential, "utility clothing" can satisfy the essence of the need here as it did in Britain. Whether we use the British model for standardizing consumer goods production, or perhaps develop one more appropriate to the American scene, is primarily a technical matter, but in a prolonged all-out effort some such program will be vitally necessary.

3. In so far as we can allow the production of nonessential goods the Purchase Tax can contribute a substantial revenue yield. Its success as a revenue producer will depend largely on the quantities of various taxable goods available to the consuming public. Thus, here as in Britain, the yield from the Purchase Tax will be directly related to the kind of emphasis the rate structure is given, whether oriented more toward revenue or control.¹⁷

4. The Purchase Tax, unlike the general sales tax and excises, is not regressive. The exemption of essentials and a finer definition of luxury and necessity under differential rates of taxation would certainly take the greatest part of the steam from the equity argument here, as it did in Great Britain. With price controls protecting consumers from extra markups after the

¹⁷ Also, of course, it will depend on the effect of the direct controls on consumer goods production.

tax charge is added, and with the lowest income group protected by the exemption of essentials, there is no reason why the measure should be politically disqualified.

Conclusion

Most of the public discussion of sales, excises, and other consumption taxes has been on somewhat of an "all-or-nothing" level. If consumption is not greatly reduced, what good? If huge revenues cannot be gained, why bother? If "justice" is not served, how dare you? To achieve any comprehensive policy able to deal with the varying requirements of our complex economy,

it must be firmly kept in mind that each individual measure is but one part of a whole. And for the sum of these parts to be equal to our needs, the play of each as part of the fiscal policy team is fully as important as its individual prowess. If, as it did in Great Britain, the Purchase Tax can fill a void in our system of controls and revenue program, then it can make a contribution much greater than any single criterion would indicate. The Purchase Tax is here commended not as "the answer" to all our revenue and control needs, but as a measure which can make an important contribution to both.

EXTRACTIVE INDUSTRIES AND THE EXCESS PROFITS TAX

DOUGLAS H. ELDRIDGE *

Introduction

THE SPECIAL treatment of extractive industries under the excess profits tax reflects a basic conflict in aims of tax policy during the defense period. One purpose of the excess profits tax is to curtail the gains derived by firms which are in strategic economic positions to benefit from the country's rearmament effort. Broad considerations of revenue needs, tax equity and prevention of economic distortions through favoritism to particular groups, argue for evenhanded treatment of all large defense profits. At the same time, the Congress has sought to utilize tax relief and concessions to encourage and foster expansion of output of natural resources. As a result these industries have been sheltered from much of the impact of the excess profits tax.

When characteristically heavy military requirements for basic materials have been superimposed on civilian demands, available supplies of many of these materials have inevitably appeared short of needs. Increased production has seemed urgent, and for some materials the urgency has been enhanced by threat of possible loss or interruption of usual imports.

The tax effects upon production in these industries may also be aggravated by the depletable nature of their assets. In exploiting limited reserves more rapidly during the emergency period, a firm may increase its current income at the sacrifice of income that would otherwise be realized later. Heavy excess profits taxation of income bunched in the defense period might be a serious deterrent to current as against deferred production.

The Excess Profits Tax Act of 1950 includes four specific relief provisions for natural resource industries, namely: (a) outright exemption of income derived from mining strategic minerals;¹ (b) outright exemption of government subsidy or bonus payments; (c) partial exemption of income from increased output; and (d) partial exemption of income of new, reactivated, or formerly submarginal properties.² While these provisions follow the general pattern developed during World War II, there

¹ *Internal Revenue Code*, sec. 450. Sec. 101 of the Excess Profits Tax Act of 1950 amends the *Internal Revenue Code* by adding a new "Subchapter D—Excess Profits Tax." In the act the various sections of this subchapter are numbered according to their place in the *Internal Revenue Code*, viz., secs. 430-472, inclusive. For this reason references made herein to parts of the excess profits tax law adopted in 1950 are in terms of the relevant sections of the *Code*.

² *Ibid.*, sec. 453.

* The author is an economist in Washington, D. C.

has been a tendency in each case to make the current exemptions more liberal.

These relief provisions of specific application to natural resource producers are in addition to a number of provisions designed to prevent hardship to small, new, or growing businesses in industry generally.³ In a number of instances the latter type of provisions is also of importance to extractive firms.

The specific excess profits tax relief for extractive industries is also supplementary to the special treatment accorded these taxpayers under the regular income tax. Producers of most commercially important minerals enjoy the privilege of deducting percentage depletion, and timber producers have the option of treating income from cutting as capital gains. These provisions serve not only to reduce regular income tax liability, but also to reduce the amount of income subject to excess profits tax. In many instances these tax privileges are more effective in mitigating the burden of excess profits taxes on extractive firms than are the specific excess profits tax exemptions. Both during World War II and in the present defense period the Congress has refused to reduce such tax concessions, lest this action might possibly impair firms' incentives and financial abilities to maintain and increase desired output.

The purpose of this article is to examine these various provisions which accord special excess profits tax relief to extractive industries, and to discuss some of the considerations which have led to their adoption.

³ For a description of these more general relief provisions see Eugene E. Oakes, "General Relief under the Excess Profits Tax," *National Tax Journal*, IV (September, 1951), p. 219.

Exemption of Strategic Minerals

Specific tax relief intended to encourage domestic production of strategic minerals was first accorded by the initial excess profits tax act of the World War II period.⁴ A precedent for outright exemption had occurred in the World War I excess profits tax under which income from gold mining was exempt.⁵ However, gold was not explicitly regarded as strategic, and no particular justification for this unique treatment appears to have been offered in committee reports or the *Congressional Record* of that earlier period.

The list of minerals granted complete exemption in 1940 was rigorously limited.⁶ All of them had been declared to be strategic materials by the War Department. They were produced in the United States only in negligible quantities, and it appeared that in normal times increased production from meager and inferior domestic resources could not compete with foreign supplies. In consequence, unusual risks were incurred in the development of properties whose commercial lives could not be expected to outlast the defense and war period.

In the following year the exemption was eliminated on the grounds that income from such mining was mainly attributable to the defense program, and it was felt that corporations so benefited should pay their share of the tax

⁴ Second Revenue Act of 1940, sec. 731. See also, Conference Committee Report, Second Revenue Bill of 1940, House Report No. 3002, 76th Cong., 3d sess., pp. 55 ff.

⁵ Revenue Act of 1918, sec. 304(c).

⁶ Tungsten, quicksilver, manganese, platinum, antimony, chromite and tin.

burden.⁷ However, the exemption was restored in 1942 upon the recommendation of the War Production Board, and was extended to four additional minerals which met the same criteria as those originally selected.⁸

With the inclusion of fluorspar and flake graphite in 1943,⁹ the standards for exemption were somewhat relaxed. While these minerals were declared by war production agencies to be of strategic importance, a large share of consumption requirements was produced in the United States and domestic commercial reserves were substantial.¹⁰ The exemption of vermiculite in the same year was more of an anomaly. Although it had war connected uses it was not classified as a strategic material by war agencies. Supplies came wholly from domestic production, and there was no lack of reserves for the foreseeable future.¹¹

In the formulation of the Excess Profits Act of 1950, the final strategic mineral provision of World War II was taken over wholesale and 12 additional minerals were added.¹² Income de-

rived by a domestic corporation by mining any of these in the United States is exempt from the excess profits tax. It is further provided that the appropriate defense agency can extend the exemption to any other mineral which it certifies as being essential to the defense effort and as not having been normally produced in appreciable quantities within the United States. The Defense Minerals Administration, as certifying agency, has subsequently added block steatite talc.

Certified minerals and most of those added by the Congress in 1950 meet both of the standards originally set for strategic exemptions in 1940. In the case of molybdenum current defense needs only seem to have governed since more than 90 per cent of total world supply comes from the United States and known domestic reserves are ample for greatly expanded output, if additional investment is made in plant and equipment. Perhaps at the extreme is the inclusion of perlite, which is used principally as an aggregate in plaster and concrete, and the case for which appears to be mainly that it competes in use with vermiculite.

The effectiveness of this type of incentive device for particularly desired minerals is probably blunted by broadening the coverage of the exemption. In an economy which is currently utilizing virtually all productive resources, any new or expanded strategic mineral project must obtain supplies of labor, equipment, and materials by hiring them away from competing uses. For an immediate or short-run increase of output of a particular mineral, effort must come for the most part from the limited number of firms already in the

⁷ House, Committee on Ways and Means, Revenue Bill of 1941, Report, 77th Cong., 1st sess., p. 26.

⁸ Senate, Committee on Finance, Revenue Bill of 1942, Report, 77th Cong., 2d sess., p. 211. The added strategics were sheet mica, tantalum, vanadium and nickel.

⁹ Revenue Act of 1943, sec. 207.

¹⁰ Cf., Senate, Subcommittee of Committee on Public Lands, *Investigation of National Resources*, Hearings, 80th Cong., 1st sess. (1947), pp. 242-245, 247-249.

¹¹ See Senate, Committee on Finance, Revenue Act of 1943, Hearings, 78th Cong., 1st sess., pp. 839-844.

¹² The minerals added in sec. 450 were: perlite, long-fibre asbestos in the form of amosite, chrysotile or crocidolite, beryl, cobalt, columbite, corundum, diamonds, kyanite (if equivalent in grade to Indian kyanite), molybdenum, monazite, quartz crystals, and uranium.

mining business, since they have advantages of know-how, organization, and equipment. Perhaps significant results could be achieved for one or a few top priority strategics through tax motivated diversion of productive efforts, but as the area of relief is widened, the results that may be expected for the most important materials become less promising.

The excess profits tax revenues foregone through the exemption of strategics appear to be comparatively slight. Potentialities for domestic production of most of these minerals are quite restricted. Even in those cases in which reserves do not severely limit expansion of output, the value of production has been small relative to total mineral production. In dollar terms, United States output of molybdenum is the most important of the exempt minerals, and the gross value of that output was \$20 million in 1948 and \$47 million in the peak World War II year, 1942.¹³

Exemption of Subsidy or Bonus Payments

Government policies of fostering mineral and timber output in war and defense periods have also been implemented in part by subsidies and direct financial assistance. When the Excess Profits Tax Act of 1950 was under consideration it was not known what form and magnitude these aid programs might assume in the present emergency period, but the Congress evidently felt that as these programs were developed, their effects in stimulating the extractive industries should be preserved and bolstered through tax exemptions.¹⁴

¹³ U. S. Department of the Interior, Bureau of Mines, *Minerals Yearbook*, 1948, p. 820.

¹⁴ Senate, Committee on Finance, Excess Profits Tax Act of 1950, Report, 81st Cong., 2d sess., p. 33.

The World War II excess profits tax exemption of income derived from government bonuses paid for mine or timber output in excess of quotas was re-enacted.¹⁵ The 1950 act also provided more generally that any government payments to encourage exploration, development or mining of critical and strategic minerals, whether by grant or loan, were to be exempt from both excess profits tax¹⁶ and regular income tax.¹⁷ The actual scope of these exemptions will be dependent, of course, on the nature and size of the subsidy programs which are being evolved.

The above-quota bonus exemption was developed during World War II as a counterpart of the premium price program for nonferrous metals.¹⁸ The government was then endeavoring to stimulate production of copper, lead and zinc by paying above ceiling prices for units of increased output. The language of the tax exemption provision was general and would have applied to above-quota bonus payments for all minerals and timber, but since this form of subsidy was used only for the nonferrous metals, actual application of the exemption was restricted. Other types of subsidies were paid, for example, to operators of stripper oil wells and to high-cost producers of aluminum and wood pulp,¹⁹ but these payments did not qualify for exemption as bonuses for increased physical

¹⁵ *Internal Revenue Code*, secs. 433 (a) (1) (I) and 453 (c).

¹⁶ *Ibid.*, sec. 433 (a) (1) (P).

¹⁷ Excess Profits Tax Act of 1950, sec. 306.

¹⁸ House, Committee on Ways and Means, Revenue Bill of 1942, Report, 77th Cong., 1st sess., p. 27. See also P. G. Frank (ed.), *Problems in Price Control: Stabilization Subsidies* (Washington: Office of Temporary Controls, OPA, 1947), pp. 60 ff.

¹⁹ Frank, *op. cit.*, pp. 55-76.

output. While data regarding the amount of excess profits tax liability eliminated through this exemption are not available, it is known that the bonus payments for nonferrous metals were fairly substantial. They were estimated to have aggregated \$250 million for the period February 1, 1942 to December 31, 1945.²⁰ Around V-E Day the proportions of total production thus subsidized were roughly 1/5 for copper, 1/4 for lead, and 1/2 for zinc.

Potentially this type of tax exemption may also be of considerable importance during the present defense period, but as yet this form of subsidy has not been utilized.

The government is now offering direct financial assistance to mineral producers in connection with exploration and development activities. Because of the methods used for these programs, however, there is some doubt as to the part of these payments which would be covered by the special tax exemption for incentive payments.

The government, through the Defense Minerals Administration, now provides direct financial assistance to prospectors to facilitate search for new ores of critical and strategic minerals.²¹ From 50 to 90 per cent of all direct costs of approved exploration projects are met by government funds on a matching principle. The prospector's share of expenses may be in the form of his labor at reasonable rates, rental of equipment owned by him, and similar contributions in kind as well as cash. If as a result of the exploration a profitable operation is established, the

government's contribution, without interest, is repayable from the net returns from ore or metal produced. Since the government in these instances is merely bearing a part of costs, or losses on unsuccessful ventures, the payments could hardly be construed to comprise taxable net income and there would seem to be no need for special tax exemption.

The Defense Minerals Administration also provides important direct financial support through guaranteed price contracts to foster the opening of new mines and the reactivation of closed or abandoned workings. These ventures differ from exploration in that a mineral body is known to exist and shows promise of profitable operation under favorable circumstances. Commonly these projects require substantial capital investment for further development of the deposit and for plant and equipment. But because of the quality of the ore or its location, costs per unit of mineral product are relatively high, and recoupment of the investment will involve a comparatively long pay-out period at relatively high product prices. The government assists the mining firms by granting favorable procurement contracts which guarantee a satisfactory price for the mine output for a number of years. These contracts, which are made on a project-by-project basis, often also contain so-called "bail-out" provisions, under which the government insures the operator and investors against financial loss in the event the contract is terminated before the end of the pay-out period. Thus, by assuring favorable operating conditions and guarantees against loss the government now offers important direct encouragement to undertake new or expansion projects. The amount of

²⁰ *Ibid.*, p. 62.

²¹ See, U. S. Department of the Interior, "Mineral Exploration Program Regulations Issued by DMA," information service release, April 11, 1951.

government funds to be allocated to this program is estimated by the Defense Minerals Administration at approximately \$3 billion for the fiscal years 1951 and 1952.

Whether, and to what extent, government payments made in connection with these development projects are exempt from excess profits and income taxes is uncertain. This type of arrangement is regarded by some as merely part of the government's materials procurement program and as being beyond the compass of exempt bonus payments. It is notable that, whereas the World War II exemption of bonus income was limited to net income attributable to output in excess of a quota, the broad language of the 1950 act places no limit on exemption of government payments to encourage development and mining, and it might seem unreasonable to have so wide an exemption as the full contract price. On the other hand, clearly one purpose of the guaranteed-price contracts is to induce developments and mining which would not otherwise be undertaken. Government payment of guaranteed high prices for new or additional output is rather analogous to premium pricing of World War II. Undoubtedly there will have to be clarification of the scope of this exemption through regulations, litigation, and/or amendment of the law, in order to mesh the present general language of the tax provision with the particular type of aid program being used.

Partial Exemption for Increased Output

The Excess Profits Tax Act of 1950 continues the type of relief developed during World War II with respect to

increased output from certain mining, natural gas, and timber properties. A portion of current income from these properties is exempt from excess profits tax. For most minerals this portion is determined by multiplying the average unit profit during the normal period, 1946 to June 30, 1950, by a specified proportion of the current production which is in excess of the average output of the normal period. In the case of coal and metal mines, timber, and natural gas properties, one-half of the net income from output in excess of normal output is exempt.

This type of relief was first developed in recognition of the character of depletable assets.²² Taxation of income from exhaustible resources at high excess profits tax rates may in some instances not only be inequitable, but may also interfere with maximum output of currently needed materials. For users of depletable assets, high emergency period profits may in part result from stepped up production which exhausts available reserves earlier than under normal conditions. For the same aggregate output over a period of years, excess profits tax liability will be greater if output is concentrated in a few years than if production were spread more evenly over the full period. This would occur even under a permanent tax since the aggregate excess profits tax credit during the period depends upon the number of years in which income is derived.²³ If the tax is imposed only temporarily, any concentration of production in the emergency-tax period,

²² House, Committee on Ways and Means, Revenue Bill of 1942, *op. cit.*, p. 27.

²³ The dependence of aggregate excess profits tax credit upon the years of actual production may to some extent be mitigated by the provision for carry-back of unused excess profits credits.

would, of course, aggravate excess profits tax liability. Then the tax weakens incentive to produce currently rather than in the future. The problem raised by bunching of income into a shorter period is less acute for industries that do not have depletable resources, since increases in their current output need not reduce future production.

To meet this problem, spokesmen for the mining industry in 1941 advanced the rather extreme proposal that all income resulting from increase in rate of extraction of a mineral deposit be excluded from excess profits taxation.²⁴ They suggested that mining companies be granted the option of a third method of computing their excess profits credit. Under this method the credit would be determined by multiplying the current year's output by the normal per-unit profit of the base period. Hence a mining company would not be subject to excess profits tax on increased earnings, no matter how large, except to the extent they resulted from a widening of the per-unit profit margin.

The Congress believed, however, that relief for income arising from accelerated output should be restricted to companies with limited reserves which would be substantially or fully exhausted in a relatively short period of time.²⁵ The apparent basis for this

view was that in these cases larger amounts of current income resulting from stepped up production would be an alternative to income that otherwise was fairly certain to be realized within a few years of normal production. But where reserves were adequate for many years, augmented current output involved only the sacrifice of much more uncertain production in the distant future. Because of the relatively large discount factors employed in the mining industries, the present value of income that may be expected to be realized twenty or more years hence is very slight. The producer who is now enabled by the defense demands to obtain income that otherwise would not be realized for twenty years or so obtains substantial benefits; he, in effect, receives currently all of the twenty years' interest on his investment in reserves and immediately recoups his capital. In consequence, it was decided that excess profits tax relief for accelerated production from mineral deposits was to be graduated according to the rate at which remaining estimated reserves were being exhausted. The general relief procedure that was developed on this premise in 1942 is continued in the present law.²⁶

General Rule for Nontaxable Income from Excess Output. All producers of metals, coal and nonmetallic minerals who have increased production from their properties are entitled to special excess profits tax relief, if their excess output (i.e., current production minus normal period production) is more than 5 per cent of estimated mineral reserves. A special deduction is allowed in computing excess profits net income, and

²⁴ See Senate, Committee on Finance, Revenue Act of 1941, hearings, 77th Cong., 1st sess., p. 876; *ibid.*, Revenue Act of 1942, 77th Cong., 2d sess., pp. 973 ff.

²⁵ Senate, Committee on Finance, Revenue Bill of 1942, Report, 77th Cong., 2d sess., p. 38 ff. Special relief for wasting asset industries under British excess profits tax levies has also been graduated according to the rate of exhaustion of natural deposits. See Hicks, Hicks, and Rostas, *The Taxation of War Wealth* (Oxford: Clarendon Press, 1941), pp. 74, 95 ff., 109.

²⁶ Internal Revenue Code, secs. 433(a)(1)(I) and 453.

the size of this deduction is graduated upward according to the rapidity with which the excess output is exhausting reserves.

Specifically, the relief deduction is the product of (1) the normal profit per unit in the base period, (2) the excess output in the taxable year, and (3) a ratio of exemption for excess output. This ratio ranges through nine classes from 20 per cent, where excess output is 5 to 10 per cent of estimated reserves, to 100 per cent, where excess output exceeds 50 per cent of estimated reserves.

Thus the type of relief desired by the mining spokesmen in 1941 is made available for properties on which excess output is rapidly depleting estimated reserves. At the other extreme, properties on which increment in output over the normal period is less than one-twentieth of reserves are not eligible for this special relief. As an incentive device to encourage stepped up production, graduated relief of this type appears more effective than a flat rate exemption. Administration is made more difficult, however, since estimated reserves must be carefully determined.²⁷

Coal and Metal Mines. Producers of coal and metals are entitled to relief under the above general rule for exempt excess output, or they may elect an alternative method of computing this type of special deduction. Under the alternative method, the nontaxable income from excess output is equal to the excess output of the property multiplied by one-half of the current unit

net income from the property. This alternative provision stems from treatment first accorded coal and iron in 1942.

It was apparent in 1942 that the general rule for exempt excess output would be of little benefit to coal producers. Defense needs were evoking large increases in output, but reserves of the industry as a whole, and of most producers, were so large that their needs could be met without substantially shortening the mines' expected commercial lives. None the less, their mineral assets were ultimately exhaustible, and spokesmen for the industry felt that they deserved some special relief.²⁸ It was also pointed out that so-called normal production had been very low, and for many of the years since World War I the coal industry had operated at a net deficit. Defense demands were currently enabling many companies to recoup past losses, restore plants, and increase their productive capacities, but the ability of the industry fully to achieve these objectives would be hampered unless excess profits tax relief for additional production were accorded.²⁹

A somewhat similar case for iron was joined with that for coal, and the alternative form of relief was first granted these two types of mines by the Revenue Act of 1942. This type of allowance seems to be more of an industry relief or incentive device than a recognition of rapidly depleting assets. In effect, half of the net income from excess output is excluded from excess

²⁸ Testimony of David Roberts, Jr., Senate, Committee on Finance, Revenue Act of 1942, Hearings, 77th Cong., 2d sess., p. 2361.

²⁹ Open letter by J. D. Battle, Executive Secretary, National Coal Association, September 18, 1942; cf., Senate, Committee on Finance, The Revenue Bill of 1942, Report, *op. cit.*, p. 538.

²⁷ Perhaps this form of relief also reinforces alleged property tax pressures on mine operators to underestimate available reserves. Understating reserves might tend both to minimize property tax assessment and to maximize excess profits tax relief.

profits tax. The exemption thus increases not only with accelerated output but also with rising prices or widening profit margins. Such an effect seems difficult to reconcile with the principle of taxing profits in excess of stated norms.

This alternative form of special relief for coal and iron was continued by the Congress in formulating the 1950 act, apparently without misgivings as to its current appropriateness, and its scope was broadened to cover all metal mines.

Natural Gas. In 1943 spokesmen for the natural gas industry asked the Congress to grant their industry excess profits tax relief for increased output, without relation to recoverable reserves.³⁰ The gas industry asked, moreover, that this relief apply not only to income derived from increased withdrawals from reserves but also to profits on transportation, storage, and distribution of the increased output. It was asserted that accelerated output due to the war effort not only hastened exhaustion of existing gas reserves, but also shortened the useful lives of extensive pipeline facilities. Their pipelines were said to be dependent upon continued supply from existing connected reserves. While depletion and depreciation deductions were allowed for recoupment of investments in computing both excess profits and income taxes, these allowances were said to be inadequate for the growing needs of the industry. Larger financial resources were required to enable discovery of additional reserves and rearrangement and extension of transportation systems. To meet these needs it was requested

that earnings from increased volume of business in all phases be partially exempt from excess profits tax. Thus relief was requested for the entire industry, including both utility and non-utility companies, and applying equally to gas purchased or produced.

This proposal for broad excess profits tax exemption was opposed by the Treasury.³¹ For many natural gas companies it did not appear that accelerated depletion of existing connected reserves would appreciably shorten the life of much of the pipeline facilities. These transportation systems generally consist of one or more main trunk lines which extend long distances, plus numerous short tributaries extending into particular supply areas. As existing wells are depleted, the companies normally and routinely rearrange their tributaries to new sources of supply within the same general region. In most of the principal producing areas the known gas reserves were large, and apparently adequate to meet demands for several decades.³² Generally accelerated depletion of connected reserves had merely resulted in speeding the normal rearrangement of tributary facilities, without significant and rapid loss in value of trunk lines and distributional facilities. In particular, companies which purchased gas and engaged solely, or mainly, in transportation and distribution seemed to have little claim for special tax relief. Their facilities would be of use as long as they could buy from various producers and well operators. Also, companies whose activities

³¹ Senate, Committee on Finance, Revenue Act of 1943, Hearings, 78th Cong., 1st sess., pp. 68 ff.

³² Cf., estimates of Bureau of Mines and Geological Survey, Senate, Subcommittee of Committee on Public Lands, *Investigation of National Resources*, op. cit., pp. 269 ff.

³⁰ House, Committee on Ways and Means, Revenue Revision of 1943, Hearings, 78th Cong., 1st sess., pp. 717-741.

were primarily in transportation, invested little if any funds in exploration effort and incurred less risk than producers who endeavored to discover and develop new reserves.

The provision of the Revenue Act of 1943 which first accorded natural gas companies partial exemption (excess output for current year multiplied by one-half of current, unit net income) was a compromise measure. The Senate had sought to grant such relief only for profits on withdrawal of gas from the taxpayers' properties and not for profits on storage, transportation, or distribution. However, the measure enacted, while restricting relief to companies operating natural gas properties in the base period, extended relief to these companies for profits on storage and transportation as well as withdrawal.³³ Under the Excess Profits Tax Act of 1950, this provision was re-enacted.

The broad relief for natural gas companies indicates the ramifications to which the rationale for exempting depletable resources may be pressed. In perspective, the grant of this relief suggests that Congress is of the following persuasion: (a) that, from the standpoint of equity, heavier taxation of current production than of alternative future production is unfair, no matter how remote and uncertain the future production may be; or (b) that, from an incentive standpoint, increased output of natural gas is more important to the defense effort than is the product of any economic activity which is fully subject to excess profits tax; and (c) that the rate of production of gas will

be adversely affected by heavy profits taxation, even if reserves are large and even if the tax is imposed on profits not only from extraction but also from vertically integrated activities.

Partial Exemption for New, Reactivated and Formerly Submarginal Properties

During World War II special relief had been provided for coal and iron mines and timber properties which had not been in operation during the base period.³⁴ This relief was an extension of the alternative excess output exemption previously granted these industries for accelerating output from operating properties.³⁵ The special deduction for new or reactivated properties was determined as one-sixth of the total net income for the current year, computed after the allowance for depletion.

In the formulation of the 1950 act, the Senate Finance Committee desired to enhance the incentive effects of this type of exemption for the opening up of new properties.³⁶ The exemption rate was doubled, from 1/6 to 1/3 of total net income. The coverage of the exemption was extended from coal, iron, and timber to include also natural gas properties and metal mines which had

³⁴ Revenue Act of 1943, sec. 208.

³⁵ See Senate, Committee on Finance, The Revenue Bill of 1943, Report, 78th Cong., 1st sess., p. 71. For a new mine or timber property a counterpart of the general rule for excess-output relief had been provided by the Revenue Act of 1942, sec. 222, in connection with arrangements for relief under sec. 722, through a constructive average base-period income. An extractive firm which was entitled to a constructive earnings credit was also to have constructive "normal output" and "normal unit profit" for purposes of determining excess-output relief.

³⁶ Senate, Committee on Finance, Excess Profits Tax Act of 1950, Report, *op. cit.*, p. 33.

³³ Conference Committee Report, Revenue Act of 1943, House Report No. 1079, 79th Cong., 2d sess., p. 60.

not been in operation in the base period. In addition, the same relief was extended to metal mines which had operated during the base period but which had incurred an aggregate net loss during that period.

Wherever the taxpayer has an excess profits credit adequate to offset 2/3 of the net income from these relief-eligible properties, the effect of the special exemption is to eliminate excess profits tax entirely.

The dominance of the incentive aim over the aim of taxing defense profits is especially clear in the case of the properties which incurred losses in the period 1946-1949. Operators of these properties are entitled to the general, liberal excess profits tax provision for credits, as well as the special allowances for new ventures, growth, or depressed conditions in the base period. If, after these adjustments, the formerly submarginal properties now yield substantial amounts of income which would be subject to excess profits tax, there is a presumption that the operators are deriving large benefits from the defense effort. Yet the Congress has regarded mineral needs as so acute that additional exemptions from excess profits tax are deemed justified for those operators.

The desirability of discovery and development of new mineral deposits seems beyond doubt, but a question may be raised regarding the merit of a differential subsidy for production from new as against existing operations. Typically the significant mineral producing companies operate a number of properties, and continuing effort is made to find new reserves as old ones are depleted. In emergency periods of defense production, total output of most mining companies has been limited

not so much by reserves, as by the scarcity of labor, equipment, and supplies. Where prices for the same product are set differently for different sources of supply, there is a strong inducement to concentrate production where the higher price is paid. This tendency to operate high-cost and low-quota mines and to neglect temporarily more productive but high-quota mines was observed in connection with premium price programs during World War II,³⁷ and the tendency was probably strengthened by the tax exemption of the bonus payments. Similarly, under the present tax exemption scheme, there may be pressure for a firm subject to excess profits tax to concentrate production among new and formerly submarginal properties. The firm might thus maximize its income after taxes even though the mineral product derived by the available amount of labor and supplies would be substantially less than that obtainable from more productive properties.

Special Treatment of Timber

Under the 1950 excess profits tax, the special relief provided for timber producers paralleled in general that for mine operators. This includes exemption of half the net income from excess output for properties operated in the normal period, exemption of one-third of net income from a timber block not in operation in the normal period, and a latent exemption of government bonus payments, which would be effective if bonuses were paid on account of production in excess of a specified quota. Broadly these were the same types of special excess profits tax relief

³⁷ Frank, *op. cit.*, p. 61.

for timber as had been enacted during World War II.

These specific relief measures appear to be of little practical importance to timber extractors, since at their option the major part of their income from timber assets is completely exempt from excess profits tax as capital gains. Under section 117(k) of the *Internal Revenue Code*, a taxpayer who cuts his own timber, or who sells timber under a cutting contract, may elect to treat the transaction as a sale or exchange of a capital asset. If the asset has been held for six months or more, the gain from sale is taxable under the present individual and corporate income taxes at a maximum effective rate of 25 per cent. Moreover, all capital gains and losses have been excluded from income subject to excess profits tax on the grounds that these are sporadic in character.³⁸ The combined effect of these tax provisions may be to exclude from excess profits taxation even the regular annual income derived from cutting timber.

The option to elect capital gains treatment was first accorded timber extractors in 1943, upon the plea of industry spokesmen that the existing heavy war taxation of timber was both inequitable and also a deterrent to maximum production.³⁹ There had been sharp wartime increases in tax rates on ordinary income without commensurate increases in the tax on capital gains. It was argued that most income of timber producers represented

gains accrued over many years and that it was unfair to tax these gains at the full rates effective in the year of realization. Existing tax treatment was said to be discriminatory since a taxpayer who sold his standing timber before cutting was entitled to capital gains treatment, but an owner who cut his own timber was fully taxed on the proceeds as ordinary income. This tax situation was alleged to be forcing transfers of timber properties which had no commercial purpose. It was also pointed out that timber had never been granted the tax benefits of percentage depletion which were enjoyed by other natural resource industries. The specific excess profits tax relief for excess output was regarded by industry spokesmen as inadequate to overcome the wartime tax deterrents to all-out production. The Congress agreed that the existing income and excess profits treatment seriously handicapped timber owners⁴⁰ and section 117(k) was added to the tax law to remedy the situation.

Taxpayers who are realizing income from timber assets are thus, at their option, free of ordinary income tax rates. Typically these are the rates which are raised to meet emergency revenue needs. These taxpayers are also practically immune from excess profits tax, even if appreciation in the value of their timber assets can be shown to have occurred largely or wholly in the period in which the tax has been applicable.⁴¹

³⁸ *Internal Revenue Code*, sec. 433(c); see also Senate, Committee on Finance, Excess Profits Tax Act of 1950, Report, *op. cit.*, p. 12.

³⁹ Revenue Act of 1943, sec. 127. See House, Committee on Ways and Means, Revenue Revision of 1943, Hearings, pp. 795-844; Senate, Committee on Finance, Revenue Act of 1943, Hearings, pp. 660-690.

⁴⁰ Senate, Committee on Finance, The Revenue Bill of 1943, Report, 78th Cong., 1st sess., p. 25.

⁴¹ Excess profits tax exemption of capital gains generally poses a similar problem. What are regarded as abnormal earnings of a taxpayer arise because of the economically strategic position which a set of assets and business organization occupy in the defense economy. Scarcities of particular types of assets combined with large defense demands may enable

This method of equalizing tax treatment among timber producers and between timber and other natural resources may have created more problems than it solved. Taxpayers in other industries may feel that their annual income does not differ essentially from income realized from timber, and they may feel that they, too, should not be taxed at ordinary rates—for example, income realized from the sale of seasoned wines or liquor, or current receipts that are attributable to patents, formulas, processes, or good will, which were developed over many past years. There are many instances in which the owner of an asset has the alternative of sale to realize immediately the capitalized value of anticipated future income rather than await the annual income himself. In other natural-resource industries some taxpayers have come to feel that the treatment accorded timber is more advantageous than the benefit they have derived from percentage depletion, and they have sought to have their income, for example, from in-oil or in-gas payment rights,⁴² or coal royalties,⁴³ taxed only at the capital gains rate.

these assets to yield spectacular quasi-rents. If the firm owning these assets operates them and realizes the quasi-rents year-by-year, it will be subject to excess profits tax. If the firm sells the assets at a value which capitalizes the abnormal defense period quasi-rents, the gain is now ignored for excess profits tax purposes.

⁴² See Senate, Committee on Finance, The Revenue Act of 1950, Report, 81st Cong., 2d sess., p. 66. The provision adopted by the Senate to give capital gains treatment for assignment of oil and gas rights was eliminated by the Conference Committee.

⁴³ See House, Committee on Ways and Means, Revenue Act of 1951, Report, 82d Cong., 1st sess., p. 117, for discussion of amendment to sec. 117(k) which would extend to coal royalties the treatment now accorded timber.

Relief Under Regular Income Tax Provisions

In a survey of special excess profits tax relief for the extractive industries, the absence of provisions for the oil industry seems curious. The apparent answer is that recent excess profits taxes have not been so burdensome on the oil industry as to require further relief and incentive measures. The general structure of the excess profits tax in combination with concessions provided by the regular income tax laws have resulted in comparatively little excess profits tax liability for this industry. These concessions have been in the form of special allowances for depletion and the privilege of currently expensing certain drilling costs.

Similar, but generally less liberal, allowances are provided under the regular tax laws for most other minerals, and it appears that these allowances are significant factors in limiting excess profits tax burdens also in these respective industries. In the United States such special allowances have not been explicitly regarded as excess profits tax relief, but as an integral part of the regular income tax.⁴⁴

These allowances are provided as alternatives to more common tax deductions which, for the most part, relate to actual historical costs and which are determined in accordance with generally accepted accounting principles. Since the early days of the modern income tax⁴⁵ mineral industries, like

⁴⁴ In contrast, under British tax law no depletion allowances were allowed for regular income tax, but special allowances for rapid use of wasting assets have been granted as specific relief from excess profits tax. See Hicks, Hicks, and Rostas, *op. cit.*, pp. 96 ff.

⁴⁵ Cf., Revenue Act of 1916, secs. 5(a) and 12(a).

other types of business enterprises have been allowed various complementary deductions designed to enable tax-free recovery of all costs incurred in producing income.⁴⁶

The special income tax allowances in excess of costs for oil and other minerals were originally the product of wartime forces similar to those which created special excess profits tax relief. During World War I Congress was concerned with the effects of the then unprecedented tax rates on the mineral industries. It was believed unfair and discouraging to mineral discoverers to tax at the full wartime rates the rewards of perhaps years of search.⁴⁷ To provide relief and to stimulate discovery, both the individual surtax and the corporation excess profits tax were limited to 20 per cent on gain from the sale of a mine or well discovered by the taxpayer,⁴⁸ and discovery depletion was

granted for mines and wells.⁴⁹ The discoverer and exploiter of a mineral deposit in an unproven tract was allowed not merely tax-free recoupment of his capital costs but deductions equal to the appreciated value of the deposit as of the time its profitability was established. The difference in a single instance was that between costs of \$250,000 and discovery depletion of approximately \$39 million.⁵⁰ One oil company through discovery depletion enjoyed tax savings of \$6.9 million in 1918 and of \$2.3 million in 1919.⁵¹

The special depletion allowances were retained in the tax law after World War I, although over the years the method of computing most of them has been changed from discovery depletion to percentage depletion.⁵² The tax advantage enjoyed under discovery depletion had varied considerably from industry to industry.⁵³ Percentage

⁴⁶ For example, costs of prospecting and exploration are deductible as current expense where not related to a specific mineral property. Where they are attributable to a particular property, these outlays are capitalized and fully recoverable from income through subsequent deductions for cost depletion or as losses on abandonment. For most types of minerals costs of developing a property are currently deductible to the extent there are receipts from output during the development stage. The excess of development costs over current receipts is charged to a capital asset account and may be recouped from later income through cost depletion. Thus on a successful mining property, the amounts of all exploration and development costs not deducted when incurred, may be recovered tax-free from the proceeds of production. If the property proves unsuccessful and is abandoned any of these costs yet unrecovered are deductible as losses.

Full tax benefit from these provisions depends, as in any business, upon adequate income to absorb the tax deductions.

⁴⁷ Senate, Committee on Finance, Revenue Bill of 1918, Report, 65th Cong., 3d sess., p. 6.

⁴⁸ Revenue Act of 1918, secs. 211(b) and 337. The individual surtax limitation has remained in the law, although the limit is now 30 per cent and pertains only to sale of oil and gas properties. *Internal Revenue Code*, sec. 105.

⁴⁹ *Ibid.*, secs. 214(a)(10) and 234(a)(9).

⁵⁰ Senate, Select Committee on Investigation of the Bureau of Internal Revenue, *Partial Report*, 69th Cong., 1st sess. (1926), p. 68.

⁵¹ *Ibid.*, p. 88.

⁵² Percentage depletion is computed as the lesser of (a) a specified rate of gross income from a mineral property, or (b) 50 per cent of net income (before depletion) from the property. The following percentages of gross income are allowed different minerals under present law: oil and gas, 27½ per cent; sulphur, 23 per cent; metals, 15 per cent; coal, 5 per cent; nonmetallics—bauxite, fluorspar, flake graphite, vermiculite, beryl, feldspar, mica, talc, lepidolite, spodumene, barite, ball, sagger and china clay, phosphate rock, rock asphalt, trona, bentonite, gilsonite, thenardite, and potash—15 per cent. In any event the taxpayer is entitled to deduct cost depletion (i.e., amounts required to amortize original investment in the property), if it is more advantageous to him than percentage depletion.

⁵³ See Senate, Select Committee on Investigation of the Bureau of Internal Revenue, *op. cit.*, for a discussion of differences in the industries which accounted for wide variations in the amounts of discovery depletion allowed.

depletion rates on gross income for oil, gas, sulphur, and metals were set by Congress at levels designed to permit the respective industries approximately the same aggregate annual deductions which they had enjoyed under discovery depletion.⁵⁴ Coal and most non-metallics derived negligible benefits from discovery depletion, and percentage depletion rates for them were selected to provide tax relief and tax incentives which seemed to the Congress appropriate as compared to rates set for oil, sulphur, and metals.⁵⁵

During World War II the Treasury recommended that, in the interest of equity to other taxpayers and to help meet revenue needs, percentage depletion deductions be curtailed.⁵⁶ Congress not only rejected the recommendation but temporarily extended this type of relief or incentive to several nonmetallics which until then had not received it.⁵⁷ Following the war these provisions were continued and also further extended to additional nonmetallics.⁵⁸ The Congress has shown little sympathy for recent expressions of the Treasury view that existing percentage

depletion allowances are excessive.⁵⁹ On the contrary, respective industry spokesmen appear to have successfully advocated doubling of the percentage depletion rate on gross income for coal and extension of percentage depletion provisions to a number of heretofore excluded nonmetallics.⁶⁰ In each case it has been argued that the industry's product is important to the defense effort and that the tax relief and incentives offered through percentage depletion are needed to encourage and facilitate finding and developing new reserves.⁶¹

At present percentage depletion deductions typically far exceed amounts required to amortize unrecovered costs. The excess of percentage depletion over cost depletion operates as a partial exemption of income from tax. In effect, after income from mineral properties is reduced by all operating costs, depreciation, cost depletion, and losses on abandonment, the net income is further reduced for tax purposes by excess percentage depletion. Treasury studies indicate that the average proportions of such net income thus excluded from tax in respective industries have in recent

⁵⁴ Senate, Committee on Finance, Revenue Act of 1926, Hearings, pp. 202 ff.; Joint Committee on Internal Revenue Taxation, *Preliminary Report on Depletion* (1929), p. 14; House, Committee on Ways and Means, Revenue Revision of 1942, Hearings, p. 1016.

⁵⁵ House, Committee on Ways and Means, Revenue Revision, 1932, Hearings, 72d Cong., 1st sess., pp. 342-347; Revenue Bill of 1932, Report, Amendment 54; Percentage Depletion, Hearings, 80th Cong., 1st sess. (1947), *passim*.

⁵⁶ House, Committee on Ways and Means, Revenue Revision of 1942, Hearings, 77th Cong., 2d sess., pp. 8 ff., 84.

⁵⁷ Revenue Act of 1942, sec. 117; Revenue Act of 1943, sec. 124.

⁵⁸ Termination of Tax Provisions Prior to End of World War II, 61. U. S. Statutes 917, c. 515 sec. 15(d).

⁵⁹ See, for example, House, Committee on Ways and Means, Revenue Revision of 1950, Hearings, 81st Cong., 2d sess., pp. 17 ff., 177-219; Revenue Revision of 1951, Hearings, 82d Cong., 1st sess., pp. 12 ff.

⁶⁰ H.R. 4473, 82d Cong., 1st sess., as it passed the House, makes new grants of percentage depletion at the rate of 15 per cent of gross income for borax, fuller's earth, tripoli, refractory and fire clay, quartzite, perlite, diatomaceous earth, metallurgical and chemical grade limestone; and at the rate of 5 per cent of gross income for asbestos, sand, gravel, stone, brick and tile clay, shale, oyster shell, clam shell, and marble. Sec. 304. See also, House, Committee on Ways and Means, Revenue Act of 1951, Report, 82d Cong., 1st sess., p. 114.

⁶¹ House, Committee on Ways and Means, Revenue Revision of 1951, Hearings, *op. cit.*, pp. 1537-1790.

years been approximately as follows: oil and gas, 40 per cent; sulphur and other nonmetallics, 33 per cent; metals and coal, 20 per cent.⁶²

Firms enjoying excess percentage depletion have an effective cushion against the impact of excess profits tax. Since percentage depletion is geared to income and is independent of actual investment costs, it rises with increases of income resulting from larger output or wider profit margins or both.

Allowances of excess depletion are of particular advantage in combination with the invested capital credit for excess profits tax. Unlike the base-period earnings which also reflect special depletion deductions comparable to those taken in the current year, the invested capital credit is computed at standard rates of return which do not take account of this special tax treatment.

The oil and gas industry also enjoys a current tax advantage through the option to expense certain capital costs. This tax treatment was first accorded through a 1917 administrative ruling, under which intangible drilling and development costs were allowed to be deducted currently as expense rather than being capitalized and subsequently recouped through depletion deductions.⁶³ In conjunction with cost depletion provisions, the privilege to expense development costs merely altered the timing of aggregate deductions for recovery of costs. However, the carrying over of this ruling into periods when discovery and percentage depletion became effective permitted double deductions for the same investment,

since these latter deductions are unaffected by the extent to which basis of the depletable asset has already been amortized. Drilling and development costs can be deducted when incurred, thus reducing current tax liability, and full percentage depletion is available to reduce tax liabilities thereafter.

This tax treatment offers strong inducement for oil and gas operators, or even investors from other industries, to invest funds in drilling and development activities, particularly in periods of high tax rates. In war and defense periods such development programs are likely to be conditioned, to some extent, by the availability of equipment and materials. But where such limitations permit, income otherwise subject to tax may be offset by current investments of this type, and both the income tax and excess profits tax are thus avoided.

Comparative Impact of Excess Profits Tax

During the World War II period the special forms of tax treatment apparently served to keep the impact of the excess profits tax on the extractive industries comparatively light.⁶⁴ In 1944, for example, only 18 per cent of total net income reported on tax returns by Mining and Quarrying corporations was subject to excess profits tax, whereas this ratio was two to three times as great for the other chief industry classifications used for *Statistics of Income, Part 2*, such as Manufacturing, Public Utilities, Trade, etc. Within the broad Manufacturing classification,

⁶² Cf., House, Committee on Ways and Means, Revenue Revision 1950, Hearings, p. 197.

⁶³ See U. S. Treasury Department, *Regulations No. 33 (Revised) Income Tax* (Washington: Government Printing Office, 1918), Article 170, pp. 83-87.

⁶⁴ See "Exhibit 1. Corporation Income and Excess Profits Tax Liabilities, 1940-45," accompanying the statement of Secretary Snyder, House, Committee on Ways and Means, Excess Profits Tax on Corporations, 1950, Hearings, 81st Cong., 2d sess., pp. 23-37.

the proportion of total net income subject to excess profits tax averaged 54.8 per cent for all groups, and ranged from a high of 72.6 per cent for manufacturers of rubber products down to a low of 11.8 per cent for integrated oil producers who refine petroleum products.

The effective rate of total corporation income and excess profits taxes on total reported net income also provides a general measure of impact. The top combined normal and surtax rate of the regular corporation income tax was 40 per cent in the latter part of World War II. In the absence of excess profits tax the effective tax rate might be expected to be some 3 or 4 percentage points below the statutory rate.⁶⁵ Among the chief industry classifications the average effective tax rates in 1944 were as follows: Mining and Quarrying, 42.5 per cent; Agriculture, Forestry, and Fisheries, 47.0 per cent; Service, 51.2 per cent; Construction, 51.2 per cent; Public Utilities, 55.8 per cent; Trade, 57.4 per cent; and Manufacturing, 61.3 per cent.

Subdivisions of these broad classes indicate that in the oil and gas industry, including both crude producers and integrated companies which are also refiners, the average total effective tax

rate was 38.8 per cent. For the metal mining group, the average rate was 38.2 per cent. Thus the average effect of the excess profits tax on these groups appears to have been minimal. The effective rate of total taxes for the forestry subgroup was 23.3 per cent, reflecting predominance of the capital gains rate.

It is also notable that for minerals entitled to excess percentage depletion, the proportion of net income subject to tax and the effective tax rate tend to be overstated. Reported taxable income in these cases is net not only of actual costs but also of excess depletion allowances, and these allowances may offset as much as half of net income computed according to general tax rules. In terms of net income computed without excess depletion, each of the types of contrasts in tax impact noted above would be widened as between mineral extraction and other industry classes.

While under the excess profits tax law the same tax rates apply to extractive industries as to others, the narrowing of the tax base through the several forms of special treatment serves to mitigate the over-all tax burden. Now, even more than during both world wars, Congress appears to feel that special tax relief to these industries is justifiable in the national interest. In this way it is hoped that deterrents to all-out production of natural resources are removed and that incentive to discover and develop new supplies may be provided by the government. In consequence, the burden imposed on extractive industries by the current excess profits tax, will probably be at least as light, relative to other industries, as in the past.

⁶⁵ The amount reported as net income on tax returns and for *Statistics of Income* is not precisely the tax base. Reported net income includes dividends received while approximately 85 per cent of these are eliminated through a credit before applying tax rates. Also totals of reported net income include such items as partially exempt interest, capital gains, and income of small corporations, which were not subject to the top combined normal and surtax rate. For some corporations the net income reported for the year may also be reduced before tax by net operating loss carry-overs from other years. Each of these items tends to lower the ratio of total tax reported net income below the full statutory tax rate.

A CONSTANT-PURCHASING-POWER SAVINGS BOND

RICHARD GOODE *

WITH THE OUTBREAK of hostilities in Korea in June, 1950, the American economy entered a period of renewed inflationary pressures. The inflation problem has been attacked by raising taxes, tightening credit, and imposing direct controls on prices and wages. But the anti-inflation program has not included effective steps to stimulate buying and holding of U.S. savings bonds.¹ Large net sales of these bonds would contribute to inflation control by helping hold spendable income of consumers in balance with available supplies of consumer goods (valued in stable prices). If savings bonds could be made attractive enough, they would freeze part of accumulated liquid balances, which now make stabilization more difficult.

Although new sales of savings bonds have continued, they have not kept up with redemptions of outstanding bonds. In the period July, 1950, through June, 1951, redemptions exceeded total new sales by \$996 million. If special sales to certain institutional investors in excess of regular limitations

are excluded, new sales under the regular program fell short of redemptions by \$1,925 million in the fiscal year ended June 30, 1951.² On balance, the savings bond program contributed to private spending power during this critical period.

The record of late 1950 and early 1951 probably reflects in part the temporary influence of consumer buying in anticipation of shortages. But lagging sales and rising redemptions may also indicate that the public is beginning to lose confidence in savings bonds because of the reduction in their real value produced by war and postwar inflation. Such a loss of confidence will make large new sales of savings bonds of the conventional type increasingly difficult and will promote redemptions of outstanding bonds.

A Proposal

One possible way of inducing buying and holding of savings bonds is to issue one or more series of constant-purchasing-power securities. As argued below, a guarantee of the purchasing power of savings bonds would probably be considerably more effective than any moderate increase in interest rates on the bonds. A purchasing-power guarantee may also be supported on equity

* When this article was written the author was assistant professor of economics at the University of Chicago. He is indebted to Milton Friedman, T. W. Schultz, Charles C. Holt, and Benjamin Solomon—all of the University of Chicago—for reading an earlier draft and making helpful criticisms and suggestions.

¹ As I am correcting the proof of this article (September 10, 1951), a new savings-bond drive is just getting under way, but it is still too early to appraise the success of the campaign.

² *Treasury Bulletin*, August, 1951, pp. 27, 38. Unless otherwise indicated, all data on savings bonds sales and redemptions used in this article are from this source.

grounds as a means of protecting bondholders from the effects of rising prices. In the present discussion, however, I shall focus attention primarily on economic effects of the proposal and give only incidental attention to its equity implications.

The proposal for a stabilized-purchasing-power bond has recently been advanced by Professor Sumner Slichter, and it has received some attention in the press.³ The idea is not new. Alfred Marshall favored it in the 1880's in his well-known suggestion of a "tabular standard" to be used for long-term debts and other contracts.⁴ J. M. Keynes, in his testimony before the Colwyn Committee in 1924, advocated a stable-purchasing-power government bond as a means of saving interest.⁵ The suggestion was also advanced in the United States during World War II.⁶

³ Sumner H. Slichter, "We Can Win the Economic 'Cold War,' Too," *New York Times Magazine*, August 13, 1950, pp. 7, 22-26, and "To Curb Inflation and Equalize Its Burden," *ibid.*, December 17, 1950, pp. 42-43. See also: *New York Times* editorials of October 25, 1950, and November 18, 1950; letters to editor, *New York Times*, October 30, 1950 (Slichter), May 20, 1951 (Renzo Bianchi), May 27, 1951 (Slichter), June 3, 1951 (A. Wilfred May); R. C. Leffingwell, "Our Fiscal and Banking Policy," *Barron's*, November 13, 1950, pp. 27-30; a series of columns by Robert P. Vanderpoel, *Chicago Sun-Times*, March, 1951.

⁴ See his evidence before the Royal Commission on the Depression of Trade and Industry, 1886, and before the Royal Commission on the Value of Gold and Silver, 1887-1888 (reprinted in *Official Papers by Alfred Marshall* [London: Macmillan & Co., Ltd., 1926], pp. 9-12, 31); also "Remedies for Fluctuations of General Prices," *The Contemporary Review*, LI (January-June, 1887).

⁵ Evidence presented to the Committee on National Debt and Taxation, *Minutes of Evidence* (London: H. M. Stationery Office, 1927), vol. I, pp. 278, 286-87.

⁶ G. L. Bach and R. A. Musgrave, "A Stable Purchasing Power Bond," *American Economic Review*, XXXI (December, 1941), 823-35.

Background of Proposal

Since 1945 net increases in holdings of savings bonds have been relatively small owing to a drop in sales and a rise in redemptions (see Table 1). Not until the second half of 1950, however, did redemptions exceed new sales of all series combined for any sustained period. Although the difference between current sales and redemptions measures the effect of the program on private spending power, the relation between new sales plus accrued discount and redemptions may be a better indication of the public's willingness to hold the bonds and hence of its confidence in them. By this standard there was net disinvestment in savings bonds in August and September, 1950, and in the first half of 1951.⁷

Series A-D savings bonds began to mature in March, 1945, and Series E, F, and G in May, 1951. Redemptions have been classified as matured or unmatured bonds only for the period beginning January, 1950, but it is clear that most of the bonds redeemed to date had not reached maturity. In the eighteen months ended June 30, 1951, matured bonds accounted for only 16 per cent of total redemptions of Series A-E bonds.

An increasing rate of redemption of unmatured savings bonds was to be expected and does not necessarily indicate loss of confidence in the bonds. A large part of postwar redemptions undoubtedly financed postponed buying of durable goods and residences and was quite consistent with the behavior urged in wartime bond-selling campaigns.

⁷ If special sales of the months October-December, 1950, are excluded, there was net disinvestment for the second half of 1950 as a whole.

The timing of redemptions, however, suggests that other influences were also at work. The postwar wave of redemptions of Series E bonds, for example, resulted in net disinvestment in 1946 in this type of security which is designed especially for small savers.

Redemptions continued to exceed sales in the second quarter of 1951, after the consumer stocking-up boom had largely subsided. The existence of this pattern suggests, although of course it does not prove, that the recent rise in redemptions in relation to sales of savings

TABLE 1
SALES AND REDEMPTIONS OF U. S. SAVINGS BONDS:
ALL SERIES COMBINED, 1935-JUNE, 1951
(Money amounts in millions of dollars)

Calendar Period	Sales	Sales plus Accrued Discount	Redemptions *	Redemptions as Per Cent of:	
				Sales	Sales plus Accrued Discount
1935-40	3,449	3,573	379	11	11
1941	3,036	3,113	168	6	5
1942	9,157	9,259	349	4	4
1943	13,729	13,898	1,585	12	11
1944	16,044	16,339	3,341	21	20
1945	12,937	13,421	5,558	43	41
1946	7,427	8,067	6,427	82	80
1947	6,694	7,436	5,126	77	69
1948	7,295	8,167	5,144	71	63
1949	5,833	6,815	5,101	88	75
1950					
Jan.-June	3,049	3,587	2,869	94	80
July-Dec.	3,025 ^b	3,590 ^b	2,970	98	83
1951					
Jan.-June	2,116	2,702	3,167	150	117
Total	93,794	99,969	42,185	45	42

* Includes sales price and accrued discount.

^b Includes sales of \$929 million in October-December, 1950, resulting from special offering of Series F and G bonds to certain classes of institutional investors in excess of regular limitations. For details of offering, see *Treasury Bulletin*, September, 1950, p. A-1.

Note: Details may not add to totals because of rounding.

Source: *Treasury Bulletin*, February, 1949, p. 25; January, 1951, p. 26; August, 1951, p. 27.

During the years 1947-1949 new sales of Series E bonds were below the 1946 rate, but redemptions declined sharply, and net sales were positive in each of these years. Declining sales fell below rising redemptions in the post-Korean period of sharply rising prices and of public discussion of the outlook for large defense spending and inflation.

bonds is partly attributable to uncertainty about the future purchasing power of the bonds.

In view of the disillusioning experience of most investors in savings bonds, it would be surprising if the securities had not lost some of their attractiveness. In real terms the vast majority of bondholders have earned no interest

and instead have suffered a marked loss of principal. Table 2 shows indexes of the redemption value of a Series E savings bond bought on December 15 of any of the years 1941 through 1949 on the same day of each successive year from 1942 to 1950. These redemption values, including both original purchase price and accrued discount, are expressed in prices of the date of purchase as measured by the B.L.S. index of consumer prices.

one essential feature is a partial or full guarantee of the purchasing power of principal and interest. The simplest type of security would be a discount bond redeemable at maturity for a sum of money equal in purchasing power to the face amount of the bond at the time of issue. It would also be possible to issue a coupon bond providing for annual or semiannual payments of interest, with or without adjustment of interest for changes in its purchasing

TABLE 2
INDEXES OF REDEMPTION VALUES OF SERIES E BONDS IN CONSTANT PRICES,
DECEMBER 15, 1941-1950 *

Index, December 15:	Date of Purchase, December 15:								
	1941	1942	1943	1944	1945	1946	1947	1948	1949
1941	100.0	....	....	....	....	....	....	....	....
1942	92.4	100.0	....	....	....	....	....	....	....
1943	90.6	97.4	100.0	....	....	....	....	....	....
1944	90.5	96.7	98.6	100.0	....	....	....	....	....
1945	90.7	96.4	97.7	98.4	100.0	....	....	....	....
1946	78.8	83.8	84.4	84.5	85.3	100.0	....	....	....
1947	74.1	78.8	79.5	79.1	79.3	92.4	100.0	....	....
1948	75.6	78.6	79.3	79.0	78.8	91.2	98.1	100.0	....
1949	80.9	84.4	83.2	82.9	82.8	95.2	101.7	103.0	100.0
1950	79.3	82.8	81.8	79.7	79.6	91.6	97.4	98.0	94.5

* Computed by deflating redemption value of \$100 Series E bond assumed to be bought on December 15 by B. L. S. consumer price index. Indexes for each bond are expressed in consumer prices of December 15 of year of purchase. Indexes of 100 are shown for year of purchase, although the earliest redemption date for a bond bought on December 15 is February 1 of the following year.

Against this background, even the most vigorous campaign to bring about large increases in holdings of the present-type savings bonds seems likely to meet an apathetic response. Redemptions of outstanding bonds may continue to finance current consumption and anticipatory buying.

Features of Constant-Purchasing-Power Bond

A constant-purchasing-power bond might take any of several forms. The

power. Adjustments of periodic interest payments for changes in price levels, however, would be somewhat inconvenient and confusing. The most appropriate measure of purchasing power of money available for writing into the bond contract is the Bureau of Labor Statistics index of consumer prices. Although this index is intended only to measure prices paid by moderate-income families in large cities, it is already well known and would probably be acceptable to other economic groups.

A maturity of at least ten years seems desirable for the special bond. In exchange for the purchasing-power guarantee the Treasury should be able to deny or restrict the privilege of redemption before maturity.

If the bonds were not redeemable before maturity, they would have to be marketable or exchangeable for marketable securities in order to permit holders to meet personal emergencies or to shift investments. Marketability almost necessarily implies that no limitation could be placed on the amount of bonds held by one owner. It would nevertheless be advisable to make the bonds ineligible for bank holding or collateral.

A marketable popular bond inevitably raises some problems. If interest rates rise, the price of the bond will fall. Holders who wish to dispose of their bonds before maturity may not understand the logic of a security that is supposed to protect them against rising prices but which sells at a discount because interest rates have increased. Actually, of course, the price of the bonds would reflect both the value of the purchasing-power guarantee and "real" interest rates. The price of the constant-purchasing-power bonds would not be depressed by a rise in nominal interest rates that was due merely to the expectation of higher commodity prices. The price of the new-type bonds might remain stable or even increase despite rising nominal interest rates on loans and securities not backed by the purchasing-power guarantee.

One way of avoiding the problems of marketability would be to make the bonds redeemable on demand but with-

out interest and without the purchasing-power guarantee if redeemed before maturity. The rationale of this arrangement would be that buyers of bonds who redeemed them before maturity would be as well off as holders of cash. Another possibility would be to pay a low rate of interest on securities redeemed before maturity but not to guarantee their purchasing power. This arrangement would put those who redeemed their bonds early in the same position as persons holding savings accounts. Denial of the purchasing-power guarantee on early redemptions would decrease the attractiveness of the bonds, if a rising price level is generally expected. Some discouragement to early redemption, however, seems appropriate. Even if redemption before maturity were penalized, the government would face a large contingent liability. But this contingent liability would be less troublesome than that represented by the present savings bonds.

If the price level fell during the term of the bonds at a faster rate than discount accrued, the option of redeeming the bonds at the original purchase price would be more advantageous to holders than the stable-purchasing-power contract. Therefore an option permitting early redemption would allow investors protection against rising prices without requiring them completely to forgo the advantages of a fixed money claim. Unless the bonds were marketable, however, a redemption option would be necessary. With the option the government's liability for the principal sum would not be reduced by a fall in the price level, but it would save interest.

Whatever type of security were issued, the government could include the option of relaxing restrictions on redemptions. If a deflationary situation developed before maturity of the bonds, they could be made redeemable on demand with interest and with or without a purchasing-power guarantee. The obvious political risk involved in this feature, however, would offset in part the advantages of greater flexibility.

Interest Rates

Given the general expectation of rising commodity prices, underwriting the purchasing power of a bond is in some respects similar to offering a higher interest rate. An important difference is that the value of the purchasing-power guarantee to an individual bondholder varies with his expectations as to the speed and extent of inflation. For those anticipating the greatest inflation, the guarantee is equivalent to a very high rate of interest. Among persons expecting inflation, the constant-purchasing-power bond, therefore, will be most attractive to those who would be least motivated by any particular increase in the rate of interest on an ordinary bond. A more important difference is that with a constant-purchasing-power bond the government bears the risk of inflation.⁸

⁸ Charles C. Holt suggests that it might be better to say that the government relieves the bondholder of the risk of inflation by simply renouncing the possibility of making a real gain from debt operations during an inflationary period. Similarly, buyers of true bonds (securities without a money redemption floor) would give up the opportunity of making a real gain from deflation. A constant-purchasing-power bond is, in this sense, less speculative for both the issuer and the purchaser than a fixed money claim.

Bondholders do not have to worry about the danger that they have underestimated the extent of inflation; hence the government need not pay an interest premium to induce investors to assume that risk. Small savers in particular may be glad to be relieved of the necessity of speculating on the future course of prices and therefore may be more attracted by a purchasing-power guarantee than by high interest rates on conventional bonds.

If the new-type bonds were freely offered without restrictions on amounts owned by one holder or on eligibility for holding, the new issue would exert upward pressure on interest rates in a period when inflation is generally expected. Investors would try to shift from fixed money claims to constant-purchasing-power bonds. This would decrease the amount of funds available for investment in government bonds not carrying the purchasing-power guarantee, corporate bonds, life insurance, real estate mortgages, and other outlets. On the other hand, when the price level is expected to fall, speculatively inclined investors would wish to shift from the stable-purchasing-power bonds to fixed money claims; if the new-type bonds were freely marketable or redeemable, the yield on fixed money assets would be forced down. The direction and extent of the influence on interest rates at any time would depend on prevailing expectations with respect to the future price level and hence the relative attractiveness of constant-purchasing-power bonds and fixed money claims.

The shifts between constant-purchasing-power bonds and fixed money claims would be similar to the shifts

that now occur between equities and fixed claims. Hence the effect on interest rates would not be an entirely new development. The upward pressure on interest rates when rising prices are expected, however, would probably be accentuated, because, unlike equities, the constant-purchasing-power government bonds would be completely secure as to principal and would appeal to conservative as well as venturesome investors.

If the government wished to limit the influence of its constant-purchasing-power bonds on interest rates, it could do so by restricting marketability or redeemability, eligibility for ownership, and size of individual holdings. Marketability and redeemability have already been discussed. Denial of bank eligibility seems appropriate and desirable, inasmuch as no useful purpose would be served by selling the bonds to banks or permitting them to be used as collateral for bank loans. Professor Slichter and most other advocates of the new-type bond have suggested that individual holdings of stable-purchasing-power bonds be limited in size, as holdings of savings bonds now are. Such a limitation is appropriate if the bonds are regarded mainly as a means of protecting small savers, but the limitation would reduce the anti-inflationary effect of the new issue. For this reason, I am not inclined to favor a limit on individual holdings.

Advantages and Disadvantages

The potential advantages of a constant-purchasing-power bond are absorption of inflationary buying power, stabilization of bond holdings, reduction of speculative buying and hoarding of durables, and protection of the

thrifty. Whether these impressive potentialities would actually be realized depends largely on how strong the appeal of the bonds would be. It is admittedly impossible to predict how sales of constant-purchasing-power bonds would compare with those of ordinary savings bonds, but it seems likely that a purchasing-power guarantee would stimulate sales. There is a strong presumption that, during an inflationary period, the new-type bonds would be held more firmly than bonds of the present type. In the early stages of the program, a large part of sales of new-type bonds would probably represent merely a shift from old-type bonds and other liquid assets. This shift would be desirable and should be encouraged because funds going into the new securities would be less likely to be withdrawn.

Constant - purchasing - power bonds would probably have their greatest attraction for relatively prosperous middle-class groups for whom saving to provide for old age and dependents is a well-established tradition. The bonds should appeal, however, to all groups who are concerned with security and adverse to speculation. The bonds would probably have a considerably wider appeal than stocks as a hedge against inflation because the principal would be safer, and purchase would be simpler and would require less knowledge.

The plan does presume a fair degree of sophistication on the part of investors. The popularity of cost-of-living clauses in wage contracts, however, indicates the prevalence of at least a rudimentary understanding of the significance of changes in the purchasing power of money and of price indexes.

A disadvantage of the plan is the risk that its announcement would be taken as an official admission that prevention of inflation is impossible. If the plan were so interpreted, a wave of anticipatory buying might speed up the inflationary process. This is undeniably a genuine danger, although its importance is hard to evaluate. An equally plausible view of the plan would see it as an expression of the Treasury's confidence that inflation will be avoided. If aided by judicious publicity, this view should prevail.

A second objection to the plan is that, if the price level rose, the government would have to make large disbursements for principal and interest when the bonds matured. If inflationary pressure still existed when the bonds were retired, it would be increased by the additional payments required by the purchasing-power pledge. This is true, but, if the plan were at all successful, it would help prevent prices from rising as much as they otherwise would. This feature, plus the greater stability of holdings, should make control of inflation easier a decade hence as well as in the immediate future. The other possibility is that prices would be lower and business in a decline when the bonds matured. If so, the government's disbursements would not contribute as much to support of purchasing power as if an equal amount of conventional bonds had been issued. An offsetting consideration, however, is the possibility that during an inflationary period sales of constant-purchasing-power bonds would exceed sales of present-type bonds by a margin large enough to compensate for the price-level adjustment at maturity.

The constant-purchasing-power bond would differ from conventional bonds in another way that might affect spending of bondholders. When the price level is rising owners of ordinary bonds and other money claims become poorer, and, if they recognize this decrease in the real value of their assets, they may spend less for current consumption. Conversely, a fall in the price level increases the real wealth of holders of conventional bonds and may induce them to spend more for current consumption. Such adjustments in consumption expenditures have the desirable effect of damping fluctuations in the general price level. Lack of this automatic stabilizing influence may be considered a disadvantage of a constant-purchasing-power bond. I am skeptical of the validity of this objection however. Sustained upward or downward movements in the price level are apt to nourish the expectation of further movements in the same direction. Therefore a rising price level often stimulates anticipatory buying and a falling price level may encourage postponement of spending. Holders of constant-purchasing-power bonds would have less incentive for speeding up or slowing down expenditures in anticipation of rising or falling price levels. Thus the constant-purchasing-power bond would have a stabilizing influence of its own. Although the point is debatable, I believe that this feature of the constant-purchasing-power bond would outweigh loss of the possible stabilizing influence of changes in the real value of ordinary savings bonds.

Another objection to the plan is that it might weaken political support for

inflation control. This argument is based on the assumption that bondholders and the groups who would buy a constant-purchasing-power bond are now one of the political forces that keep inflation within bounds and that if these groups were protected by holdings of the new-type bonds their support of anti-inflationary measures would be weaker. Although this argument has some merit, it does not seem weighty, for three reasons. First, it seems to overstate the influence of bondholders as a separate, politically conscious group. Second, bondholders would ordinarily not transfer all their money claims to constant-purchasing-power bonds. They would still have a stake in the real value of insurance, annuities, and other money claims. Third, the budgetary implications of the purchasing-power pledge might strengthen the determination of the Treasury and Congress to oppose inflation. The converse of this budgetary consideration—that opposition to deflation would be weakened—may be formally recognized, but it seems a remote possibility in view of existing political institutions and public attitudes.

A final danger is that the plan would focus irresistible political pressure on compilers of the price index. Escalator clauses and wage-stabilization problems already make the consumer price index a politically sensitive subject. The government will need to oppose demands for distortion of the index, regardless of whether constant-purchasing-power bonds are issued.

Conclusion

A constant-purchasing-power bond should not be regarded as a substitute for adequate taxation and credit restriction. These traditional measures are still the most effective means of preventing inflation. A useful supplementary means of reducing inflationary pressures is a government borrowing program that promotes new saving and freezes accumulated liquid funds. The experience of the recent past, however, suggests that the present savings bonds are now not an effective anti-inflationary weapon. The constant-purchasing-power bond offers at the least the possibility of rejuvenating the voluntary savings program.

THE FARMER'S TAX BURDEN

EDWARD L. HENRY *

ONE OF THE more difficult and interesting research areas in government finance concerns the relative tax burden borne by different groups of individuals. Attempts to estimate the ultimate tax load carried by different groups inevitably run afoul of two major obstacles, a paucity of statistical data and uncertainty as to the tax shifting process. But despite these difficulties economists have persisted in their efforts to determine the incidence of the tax structure,¹ for of course this information is basic to the formulation of intelligent fiscal policy.

Most studies of this nature have been primarily concerned with tax progression or the incidence of taxation among income classes. However, it is also desirable to appraise relative tax burdens from a somewhat different point of view. In our democracy representation is increasingly effected through economic pressure groups which tend to cut across income classes. The formulation of fiscal policy lies at the dead center of democratic government, and

it tends to become a battleground of competing economic groups seeking to use the machinery of government for their own ends.² Inevitably each group fights its tax battle in the name of "equity," and hence a disinterested appraisal of the relative tax burden borne by these groups is needed.

This article deals with the tax burden imposed upon one powerful pressure group, farmers, relative to that imposed upon other individuals. "Tax burden" is thought of as the ratio of total actual tax payments to current income but, recognizing the statistical difficulties, no attempt has been made to develop comprehensive statistical estimates of this concept. Likewise, tax shifting has been ignored. Rather, I have attempted (1) to outline developments at the local, state, and federal levels which have tended to alter the relative tax burden on farmers during the past two decades, and (2) to suggest how the farmer might fare were it possible to measure his net tax burden in more comprehensive terms.

Although the conclusions are necessarily left at an impressionistic level, it seems evident that political pressure, combined with a fortuitous distribution of representation and good times have enabled the farmer to improve greatly his relative tax position during the past twenty years.

* The author is professor of economics and political science at Mount St. Scholastica and St. Benedict's Colleges in Atchison, Kansas.

¹ Carl Shoup and others, *Facing the Tax Problem* (New York: Twentieth Century Fund, Inc., 1937), Chapter 16; Gerhard Colm and Helen Tarasov, *Who Pays the Taxes?* (Washington: Temporary National Economic Committee, 1940); Helen Tarasov, *Who Does Pay the Taxes?* (New York: New School for Social Research, 1942); R. A. Musgrave and others, "Distribution of Tax Payments by Income Groups: A Case Study for 1948," *National Tax Journal*, IV (1951), p. 1; and Rufus S. Tucker, "Distribution of Tax Burdens in 1948," *National Tax Journal*, IV (1951), p. 269.

² For an interesting analysis of the political aspects of fiscal policy see E. P. Herring, "The Politics of Fiscal Policy," *Yale Law Review*, XLVII (March, 1938), p. 724.

The Earlier Burden of the Property Tax

For a number of years following the turn of the century the farmer, because of his role as a major property holder, found his tax burden continually rising as local expenditures grew and were financed almost wholly by levies on property. If one considers that even as late as 1940, 70 per cent of the taxes paid directly by farmers were property taxes, one can appreciate the contention of farming organizations that the revenue system was weighted against the farmer.

One of the major complaints against the tax has been its inflexible drain on income. Historically, farm income has fluctuated more widely than national income and, as a result, periods of depressed income have aggravated the burden for the farmer. This was particularly true through the twenties and early thirties. Between 1925 and 1932, farm income declined 58 per cent, but the total farm real estate tax declined only 11 per cent; thus in the later year farmers paid more than twice as high a percentage of their gross income in these taxes.³ This change worsened an already bad situation. A 1924 survey, for example, made in Dane County, Wisconsin, indicates that farmers in that county paid as direct taxes nearly three times as large a fraction of their net incomes as did city and village people.⁴

³ Eric Englund, "Rural Taxation," U. S. Department of Agriculture, *Yearbook* (Washington: Government Printing Office, 1940), p. 779.

⁴ B. H. Hibbard and B. W. Allin, *Tax Burdens Compared*, Agricultural Experiment Station, *Bulletin* 393 (Madison, Wisconsin: March, 1927).

Another major objection thrown against the tax is that real property was singled out for special taxation while other types of wealth which characterize modern economies were either ignored or taxed less heavily. For a number of years there was a general drift away from taxation of intangibles, and personal tangibles were very lightly taxed. The net result focused local tax systems on real property. Those whose incomes were not connected with property or whose property was in the form of intangibles were wholly or partially exempt from the property tax.

The farmer was a natural victim of this discrimination because the bulk of his income was associated with real property and because he owned relatively less intangible property than most other economic groups. A 1935 study of probate court records in Texas, for example, showed that 48 per cent of all property probated was in intangibles. Yet 97 per cent of the property assessed for property tax purposes was tangible.⁵ Intangible property constituted 32 per cent of property probated in rural communities; 50 per cent in city communities. As a result the farmer had to expose to the property tax a higher proportion of his property than did the urbanite.

The widespread distinction between intangible, other personal, and real property led the Assistant Chief of the Bureau of Agricultural Economics in 1940 to charge that other forms of wealth had in large measure eluded the

⁵ L. P. Gabbard, *Relative Importance of Intangible Property in Texas*, Texas Agricultural Experiment Station, *Bulletin* 505 (College Station, Texas: February, 1935), pp. 5-15.

general property tax and that difficulty in hiding land and improvements had caused a rise in burden on the farmer.⁶ Other types of discrimination in administration of the tax were also evident, such as overvaluation of agricultural properties relative to industrial.⁷

Criticism of Property Tax Less Warranted Today

Although complaints against the property tax persist today, particularly in farming circles, there are reasons to believe that some of the more objectionable features of this tax are being overcome, and further that the farmers' position with respect to property taxation now compares quite favorably with that of other groups. Among the reasons which can be cited are (1) tax reform, substantive and administrative, (2) the declining importance of the property tax in state systems, and (3) an increase in the farmer's ability to pay.⁸

Tax Reform

Partially as a result of incisive farmer criticism during the depression, attempts have been made in almost all states to mitigate the property tax burden. Generally these attempts involve (1) limitations on the use of the property tax for revenue purposes and (2) a widening of the state tax base to include additional types of taxes, thereby lessening the pressure on property. The

recommendations of the Pennsylvania Tax Study Committee as reported in this *Journal* in December, 1949, may be cited as an example of these efforts.⁹ This committee recommended a ceiling on local tax rates and the raising of new revenues by the state to be shared with localities, the objective being to relieve local pressure on the property tax.

In addition, tax classification was extended during the thirties to afford relief to certain types of properties. The farmers seem to have fared well in this movement. In some states agricultural machinery now goes free of tax. Kansas frees crops in the fields and assesses cattle at a more favorable ratio than most other property. Minnesota gives the farmer liberal homestead exemptions. Kentucky taxes refrigerators four times more heavily than farm machinery, and so classification goes. At the present time three-fourths of the states have constitutions permitting property classification and, of these, half levy classified real property taxes.

The relative position of the farmer has been further improved by attempts to tax intangibles through such classification. By 1948 only 11 states formally exempted such intangibles from property taxation.¹⁰ There seems to be evidence that better reporting from source has improved the assessment of intangibles within recent years.¹¹ Surveys show that a lower rate or a more

⁹ Pennsylvania Tax Study Committee, "Report of Findings of Recommendations on the Pennsylvania Tax System," *National Tax Journal*, II (1949), p. 377.

¹⁰ Commerce Clearing House, Inc., *Tax Systems*, XI (Chicago: January, 1948), pp. 140-151.

¹¹ James Martin, "The Property Tax and the Economy," *Annals*, CCXXVI (November, 1949), p. 140.

⁶ Englund, *op. cit.*, p. 776.

⁷ See H. C. Reeves and Lea Pardue, "Some Reasons Why Property Is Poorly Assessed for Taxation," *National Tax Journal*, I (1948), p. 366.

⁸ Tax capitalization may not be ignored but to the extent that it has reduced the property tax burden it is no new development.

favorable ratio of assessed-to-true value reduces evasion. Such statutory and administrative improvements in the tax will most likely result in greater utilization of it by the states, thus diminishing one source of discrimination against the farmer.

Declining Importance of Property Tax

A second major factor making criticism of the property tax less warranted today is the declining importance of property taxation in the state tax picture. New sources of revenue have been devised to meet the rising costs of government, most of them since the depression of the early thirties. Sales, income, and gross receipts taxes have lowered the proportionate importance of property taxes and probably the relative burden of the farmer. While total state property tax collections rose only 12.6 per cent from 1942 to 1950, sales and gross receipts taxes rose 111 per cent; license and privilege taxes 75 per cent; and income taxes 155 per cent.¹² By 1951 the property tax had virtually disappeared as a major source of state tax revenue; in 1950 it provided only 2.6 per cent of state general revenues.¹³ Three states have abandoned the tax completely and only 11 states reap \$10 million or more from it.¹⁴

This expansion of other taxes has enabled localities to reduce their reliance on the property tax as a result of tax sharing and subsidies. In 1890 local governments raised more than 92 per

cent of their revenue from the property tax. By 1947 only 55 per cent of their revenues came from this tax source.¹⁵ This trend is largely explained by the fact that state governments are today distributing 30 per cent of their general revenues to localities. The states have been able to do this not only because of the exploitation of additional tax sources but also because of the receipt of financial help from the Federal Government, today 150 per cent greater than in 1942.¹⁶

Michigan offers a dramatic example of how substitution of other taxes for property taxes has afforded tax relief to the farmer and even windfall profits where the property tax had been capitalized.¹⁷ There the support of rural roads has been shifted almost entirely from the property tax to the gasoline tax and motor vehicle revenues. Sales and liquor tax revenues have greatly increased while revenues from the property tax are today only one-third as large as in 1930. Liberal exemptions under the sales tax for certain farm-purchased goods such as machinery, fertilizer, and feed have really tended to shift the tax burden to other shoulders. This particular reform was forced by constitutional amendment supported by rural interests and fought by the large cities. In 1946 another successful movement was initiated in Michigan for an amendment that would force the

¹² Alfred G. Buehler, "The Property Tax as a Local Revenue," *National Tax Journal*, I (1948), p. 369.

¹³ United States Bureau of Census, *Compendium of State Government Finances in 1950* (June, 1951), p. 6.

¹⁴ D. C. Cline, *Michigan Tax Trends*, Agricultural Experiment Station, *Bulletin* 301 (Lansing: February, 1940), p. 75.

¹² United States Bureau of Census, *Sources of State Tax Revenue in 1950* (November, 1950), p. 2.

¹³ United States Bureau of Census, *Compendium of State Government Finances in 1950* (June, 1951), p. 6.

¹⁴ United States Bureau of Census, *State Tax Collections in 1950* (August, 1950), p. 2.

state to return 75 per cent of the proceeds of the sales tax to localities. Chief beneficiaries seem to be school districts and townships many of which no longer find it necessary to levy any property tax whatsoever.¹⁸

The Michigan experience is apt to be repeated elsewhere, if not in such dramatic form. It seems probable, according to some people close to local finances, that property taxes will almost certainly continue to decline in the future relative to income, sales, and business taxes. They are also likely to decline relative to the value of property.¹⁹

Ability to Pay Has Increased

A third factor that has made the property tax less oppressive since the depression has been the rise of farm income. As pointed out previously, the property tax is inelastic to the taxpayer because it varies less than income from property, thus aggravating the farmer's plight in poor times, lessening his burden in good times. The drop of farm income between World War I and 1933 aggravated the property tax burden. Following 1933, however, farm income at first rose slowly for several years and then staged a sharp rise. Since 1940 the percentage rise in total cash farm income has been substantially larger than that in the value of farm lands per acre.²⁰ Nor did assessed values rise as much as market prices after 1940.²¹ This situation has, of

course, tended to reduce the ratio of property taxes to income and lighten the tax burden. A drop in income would again intensify the burden of property taxation, but with the advent of parity it appears that farm income would have an upward rather than a downward elasticity.

One further point may be mentioned. The property tax is deductible in computing federal income taxes. As a result the net cost of the property tax is generally less than the nominal amount of the tax, the tax saving being absorbed by the Federal Government. The farmer has experienced a comparative gain to the extent that an income rise has enabled him to use the property tax deduction, whereas he previously fell outside the income tax range for lack of income. In this period of rising income taxes and rising farm incomes, the burden of the property tax has thus been turned to the farmer's advantage in this sense.

In summary, we may say that the relative burden of the property tax on the American farmer has declined greatly. Property tax reform movements, substitution of new sources of revenue which do not impinge as heavily on the farmer, and substantial increases in farm revenue have all mitigated the burden.

The State Tax Burden

A realistic appraisal of tax burden, however, cannot be restricted to any one level of government. A comprehensive inquiry requires an examination of the relative tax burden at all three levels of our federal system. An advantage or disadvantage at one level may be more than offset at another.

¹⁸ R. S. Ford, "State and Local Finance," *Annals*, CCXXVI (November, 1949), p. 22.

¹⁹ *American City* (February, 1951), p. 124.

²⁰ *Business Bulletin* (Cleveland Trust Company, March 16, 1951).

²¹ Edward D. Allen, "Postwar Prospects for Agricultural Land Values and Property Tax Assessments," National Tax Association, *Proceedings* (1945), pp. 217-229.

We have already discussed the probability that the farmer is finding some relief at the local level where the great bulk of the revenues is derived from property taxation.²²

There is also some indication that state taxes rest no more heavily on the farmer than on other groups, probably less so.²³ As indicated above, states are looking elsewhere than to property for revenues; chiefly to sales and income taxation. These replacement taxes probably bear less heavily on the farmer than the property taxes.

A general sales tax, for example, will be more of a burden to an urbanite than a farmer. Farm families tend to begin saving at lower income levels than do urban consumers, and they have more imputed income. Thus sales taxes falling on them are smaller both in absolute terms and in relation to income.²⁴ A study made of the effects of a federal sales tax on the farmer is applicable in part to a state sales tax. This study pointed out that farmers with money incomes over \$1,000 spend significantly less on taxable goods and services than nonfarm groups, and that as a group farmers would pay less retail sales tax.²⁵ Furthermore, such sales taxes would be included in parity, and farm prices would then reflect the tax.²⁶

²² W. J. Shultz and C. L. Harriss, *American Public Finance* (New York: Prentice-Hall, Inc., 1949), p. 318.

²³ As indicated elsewhere in this paper, property taxes last year constituted a mere 2.6 per cent of state general revenues.

²⁴ Helen Tarasov, *Who Does Pay the Taxes?* (New York: New School for Social Research, 1942) p. 9.

²⁵ Tyler F. Haygood, "How Would a Federal Sales Tax Affect Farmers?" *Journal of Farm Economics*, XXVII (1945), p. 649.

²⁶ H. P. Wald, "Variations of Retail Sales Taxes," *American Economic Review*, XXXIV (1944), p. 294.

For reasons which will be discussed below, the state personal income taxes likewise bear less heavily upon the farmer.

If at the state level, therefore, the property tax has declined greatly in relative importance and if the replacement mainstays are favorable to the farmer, it would appear evident that he now enjoys a relative advantage in tax burden at this level of government.

The Federal Level

What about federal taxes? How significant in the total picture are they? How do they treat the farmer? In 1930 federal tax collections were only two-thirds as large as local collections, twice as large as state collections. Localities took in \$5 billion, the Federal Government \$3.5 billion, and the states \$1.8 billion. Since then the picture has changed drastically. On the basis of pending legislation, federal tax collections may reach \$61 billion in the present fiscal year. This compares with an estimated state and local tax collection of \$16 billion.²⁷ It is clear that the importance of federal revenues today far outstrips that of state-local receipts.

In this huge tax take, federal personal income taxes for the last several years have approximated 50 per cent of net budget receipts, an amount by itself greater than combined state-local revenues. An advantageous position with reference to this tremendous revenue raiser alone could well offset all other tax disadvantages. And in this single most important tax the farmer seems to be relatively better treated than most other groups.

²⁷ *Monthly Letter on Economic Conditions* (New York: National City Bank, February, 1951), p. 19.

There are two major reasons why this is true: (1) the difficulties involved in formulating a complete statutory definition of income; and (2) the administrative difficulties besetting enforcement of the statute.

Inadequate Statutory Definitions of Income

Income in the federal and state laws is defined as an accounting rather than an economic concept. In general, monetary income is the measure of accretion to the exclusion of nonmonetary or imputed income.²⁸ Among examples of nonmonetary income which escape taxation are home-grown food and fuel, home-ownership, and self-help in the home.

Farmers seem to be heavily favored with reference to imputed income because they generally own their homes or can count rental as a deductible business expense, and because they produce more than other groups for their own consumption. With the possible exception of the members of the armed forces, farmers are the only large group to receive a major portion of their income in kind.²⁹ Legislators are not unaware of this as is evidenced by attempts to tax such income,³⁰ but

²⁸ Henry Simons and William Vickrey have given excellent treatment to the latter aspects of income in their works.

Henry Simons, *Personal Income Taxation* (University of Chicago Press, 1938), Chapters 2 and 5; William Vickrey, *Agenda for Progressive Taxation* (New York: Ronald Press Co., 1947), Chapter 2.

²⁹ E. W. Grove and Nathan M. Koffsky, "Measuring the Income of Farm People," *Journal of Farm Economics*, XXXI (1949), p. 1103.

³⁰ Australia imputes 5 per cent of the value of the home as income to the owner. The Civil War income tax had a similar provision. Wisconsin imputes as income to the farmer \$90 per adult and \$60 per child as income for home-produced foods. England makes an adjustment between income of women working outside and those working at home.

administrative difficulties have been pronounced and today such income is generally ignored. This means that a not insignificant portion of the real income of farmers escapes taxation.

Administrative Advantages for the Farmer

The farmer also benefits from difficulties attending the enforcement of the tax. Internal Revenue field agents regard the farmer as one of the most difficult of their assignments. The *Internal Revenue Code* states that all except laborers, salaried workers and farmers must keep "permanent books of account or records, including inventories."³¹ The urban worker, however, has his income reported accurately through collection-at-the-source methods, while his employer must under law keep records on his own transactions. The farmer on the other hand is not required to keep books although he must be able to explain and justify transactions once they are discovered. Very probably this is not a decisive advantage for the large farms, but it is for the millions of smaller farmers who keep only haphazard records, or, indeed, none at all. The time-consuming efforts involved in going over such records together with the fact that a large portion of farm income represents small cash transactions not easily traceable, has tended to discourage enforcement practices with reference to the farmer.

Surveys conducted by both the Bureau of Agricultural Economics and the Bureau of Census have revealed biases toward underreporting of income by farmers. Such underreporting, the

³¹ *Internal Revenue Code*, section 29.54-1, Regulation 111.

surveys indicate, is more pronounced in the case of the farmer than for most other occupational groups. A Census survey in 1946 accounted for more than 90 per cent of total urban wages and salaries, but only about half of total net cash farm income.³² While these surveys were not primarily intended as a check on enforcement, nevertheless, they do underline the extent of the problem involved in ascertaining farm income. Roy Blough, former director of the Division of Tax Research of the U. S. Treasury Department, has said that under present enforcement practices farmers, self-employed, and domestic servants probably escape taxes in large numbers. He indicated that, in general, rural America is relatively undertaxed by the income tax.³³ At least one other tax authority has taken a similar position.³⁴ And while the trend toward increasingly rigorous attention to enforcement may put greater pressure on farmers to report income more accurately, at the same time this pressure may be nullified by the increasing incentive for farmers to take advantage of their peculiar position in the tax structure as taxes continue to rise.

One other point may be mentioned with reference to the federal tax burden. Farm organizations have generally succeeded in excluding farm labor from many benefits of labor legislation such as unemployment insurance, workmen's compensation, wage and hour rules, and

old age insurance. This is a substantial disadvantage for the farm laborer, but it means that the larger farm operators, unlike the urban businessmen, save the social security taxes involved.

The Over-All Picture

To summarize, at the federal level the evidence points to a favored tax position for the farmer relative to other economic groups. This is due particularly to the personal income tax which because of intrinsic and administrative defects fails to tap the entire economic income of the farmer. Although we have no statistical measurement of the extent of this advantage in dollar and cents terms, one may venture to say that it is substantial in view of the dominant place of the income tax in our revenue system. This advantage, when added to other evidence of burden on the farmer, would seem to justify the conclusion that the farmer has a relative tax advantage at the state and federal level if not at the local one, and that his over-all tax position with respect to other economic groups is a favorable one.

Two prior studies which have made elaborate use of statistics in estimating the tax burden by income classes, seem to agree in passing that, contrary to frequent assertions, farmers bore a lower tax burden than urban dwellers and/or salaried workers at the time the studies were made.³⁵ It is significant that these conclusions were reached before the era of really heavy income taxation. Such a survey made today would in all probability show an even more decisive advantage for the farmer than prior to World War II.

³² Grove and Koffsky, *op. cit.*, p. 1108.

³³ Roy Blough, "The Issue of Diversification in Tax Policy," *Tax Law Review*, III (New York: University School of Law, October-November, 1947), pp. 13, 14.

³⁴ Roswell Magill, *Impact of Federal Taxes* (New York: Columbia University Press, 1943), p. 35.

³⁵ Carl Shoup and others, *op. cit.*, pp. 221 ff.; Helen Tarasov, *op. cit.*, p. 9.

A Net Burden Concept

The expenditure side of fiscal policy cannot be lightly brushed aside—a taxpayer not only pays money into the government coffers, he gets something back for it. Theoretically, the aforementioned burden concept (ratio of taxes to income) should be broadened to include the benefits of government expenditures so that a net burden conclusion could be arrived at for purposes of comparison. Such a concept might compute relative burdens on the basis of taxes paid less benefits received as a proportion of income.

This formula would appear to accentuate the advantages to the farmer suggested by the previous, more circumscribed burden concept. For instance, analysis of local property taxes in an agricultural community would show a high degree of correlation between taxes paid and benefits received. The reputed weight of the property tax would then lose much of its significance.

But the limitations of this net burden concept are obvious. In practical terms such a formula may well be difficult or impossible of application. The statistical job alone would be staggering even if it were possible to collect comprehensive expenditure data and then allocate by economic groups. It may well be that conclusions with reference to this net burden concept will remain quite unscientific, or at best, will be based upon a variety of highly questionable assumptions.

In very general terms, however, it may be justified to say that a conservative evaluation of farmer participation in expenditure benefits will place him on a level at least equal to

that of other groups in society. This would appear to be particularly true of the period since 1933 when an era of increased agricultural appropriations was introduced. And it may be added that the farmer enjoyed considerable direct services from the government for many decades prior to that year. Outright grants, indeed, are perhaps not the most important concessions that should be considered. To the more self-evident services we must add the savings to the farmer occasioned by farmer-initiated repressive legislation on other economic groups such as railroads, stockyards, margarine producers, etc. Eric Englund, for many years associated with the Department of Agriculture as an agricultural economist, cautiously admitted as early as 1940 that "large subventions from revenues collected largely outside of rural communities go a long way toward counter-balancing direct rural taxes."³⁶

If the farmer's economic position relative to other groups has improved greatly over the past two decades, politics has played its part in no small way. The farm bloc, organized in the early 1920's has persisted as one of the strongest groupings in Congress. This is particularly true of the Senate where the farm states are proportionately overrepresented, and of congressional committees where the greater political stability of rural voting areas has moved rural representatives into important posts. In many instances a disproportionate farm-interest bias has been imparted to legislation. Although taxpayer associations complain about the cost of farm legislation, their protests

³⁶ Eric Englund, *op. cit.*, p. 787.

go unheeded largely because there is no urban bloc to offset the farm bloc.³⁷

Farmer groups are well aware of the long run importance of tax and expenditure policies on their economic position in society, judging by their alertness when such policies are being formulated. A shift in the tax structure against the farmer or a diminution in the financial aid tendered him would disturb his newly won economic

position and ultimately his political position. No economic group possessing political strength will accept the consequences of such change; and this is an effective reason why such political pressures by groups such as the farm bloc are centered on fiscal policy. To the extent that economists can perfect their research techniques in this area of relative burdens, they will be providing the basis for what might be a more precise and rational resolution of such fiscal policy conflicts.

³⁷ See Dayton McKeon, *Party and Pressure Politics* (New York: Houghton Mifflin Co., 1949), p. 454 ff.

TAXATION OF INTANGIBLE PERSONAL PROPERTY IN OHIO

GEORGE W. THATCHER *

THIS ARTICLE presents a brief description and critique of the taxation of intangible personal property in Ohio. In my judgment the experience of Ohio is significant because it shows that intangible personal property can be effectively reached by a properly constructed classified tax on intangible property. The case for this method of taxing intangible property is especially strong in states in which an income tax cannot be levied for constitutional or other reasons.

The General Issues

Before discussing the experience of Ohio it will be helpful to review briefly the general issues involved in the proper tax treatment of intangible personal property. The problem originated to a large extent with the introduction of the corporate form of business organization and the development of modern banking. These developments led to a vast increase in intangible property, such as stocks, bonds, bank deposits, accounts receivable, promissory notes, mortgages, and other credits, but only a small fraction of these found their way onto assessment lists. The wholesale evasion of the tax on intangible property has led most tax experts to

agree that the general property tax has been a failure in so far as this type of personal property is concerned.

Part of this failure can be attributed to a lack of a rational concept of taxable property. The assumption that all property is homogeneous and should be taxed uniformly led only to injustice and confusion. If intangible personalty is to continue to be taxed, a more rational concept of taxable property must be developed which recognizes the inherent differences that exist between various forms of intangible property. Intangibles represent diverse degrees of ownership and control in underlying economic goods and hence should be taxed differently.

Based upon the relationship between wealth and income, intangible personal property is generally divided into two distinct classes: namely, representative and nonrepresentative. Representative intangible property consists of real estate mortgages and usually industrial bonds, common stock, and preferred stock. The second group, nonrepresentative intangibles, includes in general good will, franchises, royalties, patent rights, and government bonds.

The inclusion of representative intangibles in the concept of taxable property has brought widespread criticism. The critics of this inclusion claim that taxation of representative intangible property as other property results in

* The author is associate professor of economics at Miami University. The material on which the article is based is taken from the author's doctoral dissertation, "Taxation of Property in Ohio," which is on file with the University of Wisconsin.

serious inequities. Corporation stock, they say, represents nothing more than an equitable interest in the net assets of a corporation and certain rights of voting and participating in the earnings of the company. Bonds represent various other rights and interests which the bondholder has in the corporate property and income. If then the physical property of the corporation is taxed, an additional property tax on stocks and bonds (which merely apportion equities and rights among the owners and creditors of the corporation) would place a double tax burden on the same property. Further, it is argued, the tax on the property of a corporation reduces the income to the shareholder and an additional tax on the shares places a double burden on the property of the stockholder. This double taxation problem is accentuated by nonuniform assessment practices and exemption policies, and by the discriminatory burden which is placed upon corporations as compared with unincorporated business.

Other critics would accept the validity of this argument but would regard it as immaterial. They believe the pertinent considerations are that such representative property is property in the legal sense; that it constitutes an important part of the wealth of individuals; and that it has a market value and yields an income to the owner.

Professor Harley L. Lutz has summarized this viewpoint as follows:¹

It does not follow (merely because a considerable part of intangible wealth is representative wealth) that taxation of the physical assets of the corporation where they are located always constitutes adequate taxation of the representative wealth. This

position assumes that the taxes on the property of the corporation always fall on the holders of its securities, but such a position is in large degree untenable. For example, the interest rate paid on corporation bonds is governed by the conditions of the general money market at the time of issue. Likewise, the dividend rate on corporate preferred stock is established more or less by custom and by the general investment attitude toward this type of security. The rates of return that are paid by the corporation on its bonds and on its preferred stock are not affected by the property taxes paid by the company unless these become so heavy as to threaten insolvency. Consequently, neither the bondholder nor the preferred stockholder is taxed or otherwise inconvenienced by the taxation of the corporate property. The common stockholder, being the residual claimant to the corporate net income, is the only owner of the corporate representative wealth for whom a true case of double taxation can be made.

In my judgment, Professor Lutz's statement in no way disproves the argument that the treatment of mortgages under the general property tax also results in double taxation. The fact remains that there has been no increase in wealth or taxpaying ability through the creation of the mortgage. The mortgage represents nothing but an equity in the property. Therefore, it is, in my judgment, objectionable double taxation to tax both the creditor and mortgagee on the "full value" of the property with no offset for the debt. This position has been taken by a number of state courts although the "great weight of authority" is on the side which holds that it does not constitute double taxation in an obnoxious constitutional sense.

From this discussion, it appears that the concept of taxable property would

¹ Harley L. Lutz, *Public Finance* (4th ed., New York: Appleton Century, 1947), p. 370.

be clarified if representative property were removed from the scope of the general property tax. But, according to some experts, to do so would result in a discriminatory and nonuniform taxation. They argue that if all representative personalty were uniformly taxed, the tax would be universalized and would not be objectionable. Unfortunately, the problem is more complicated. All physical property does not have intangible manifestations and it would be impossible to universalize double taxation of representative property and actual wealth. The weight of this argument indicates that a rational concept of taxable property demands exemption of representative intangible property from taxation.

Another cogent argument against the taxation of representative intangibles under a general property tax is that wholesale evasion results. There has been a general acquiescence on the part of both tax administrators and the taxpayers in the nonenforcement of the tax. This is largely due to the inability of the assessors to discover the various types of intangibles for assessment purposes and to the unwillingness of the owners voluntarily to report such property for taxation. This unwillingness to report intangibles is due in part to the high rates of the general property tax. Rising governmental costs and continued evasion of intangibles from assessment in turn increase the rates of taxation which, to complete the circle, stimulate further evasion. A vicious circle of cause and effect operates.

Further, the wide variation in rates and ratios of assessed to true value between districts encourages evasion by migration particularly in the high rate districts. In fact, the very inequality

and lack of theoretical justification of the tax makes evasion, as one author said, look like "a case of self help for the correction of what to many seems to be a gross injustice."

Nonrepresentative intangibles, the second class of intangibles, are property both in a legal and in an economic sense. Taxation of such property does not result in double taxation but certainly leads to discrimination. Such property is extremely difficult to segregate from other values for purposes of taxation. The sheer complexity of the task causes many differences in the treatment of enterprises and individuals. In my view, this discrimination is sufficient grounds for exemption of such intangibles from a general property tax.

The arguments in favor of continued taxation of nonrepresentative intangibles are twofold. First, the tax yields a considerable revenue to the local units of government, which at present are sorely in need of such revenue. Second, to exempt intangible personalty violates the general idea of uniformity—that all property should be taxed. Such exemption would, in essence, penalize taxpayers who refrain from investing in intangibles and purchase real property and tangible personalty.

In my judgment, the weight of the argument rests in favor of the abandonment of the general property tax on intangible personalty. I recognize that many state and local units obtain revenue from this source, but revenue requirements may be met from many sources. The real question is which source gives the most equitable distribution of the tax burden. The taxation of intangibles under a general property tax results in a purposeless discrimination among taxpayers which is

inherent in both the application and the administration of the tax. Because of the inevitability of this discrimination, the exemption of intangibles from the general property tax would seem to be the proper treatment. This does not mean that intangibles should be exempt from all taxation. The income yield may be subjected equitably to personal and corporation income taxation. In states which levy no income tax, consideration should be given to a more equitable classification of intangibles for tax purposes. We turn now to a consideration of the way in which Ohio has solved this problem.

*The Taxation of Intangible Personal Property in Ohio*²

The present tax on intangible personal property in Ohio was adopted in 1931. The basis of assessment is all moneys, credits, investments, deposits, and other intangible property of both residents of this state and of nonresidents when used in and arising out of business transactions in Ohio. Such property of residents used in and arising out of business transacted outside this state is not subject to taxation. It is clear that Ohio has attempted to clarify the problem of determining the situs of intangibles for taxation by adopting the common-law rule of domiciliary situs, but modifying it by making provision for "business situs." The legislature has written into the law the intention that the principle of business situs "shall be reciprocally applied to the end that all property . . . having a business situs in this state shall be

taxed herein and no property . . . belonging to a person residing in this state and having a business situs outside of this state shall be taxed."

Basis of Assessment and Rate of Taxation. The unique feature of the taxation of intangible personal property in Ohio is that it combines a tax measured by income from "productive investments" and a low-rate property tax on the true value of "unproductive investments" and other nonincome yielding intangible property.

Productive investments are taxed at 5 per cent of their income yield. They include such items as shares of stock, bonds, certificates of indebtedness, notes, annuities, royalties, and other equitable interests. Those of the above classes of property which yield no income are designated as unproductive investments and are subject to a rate of 2 mills on the dollar. Stock dividends of the issuing corporation are not recognized as income yield.

Deposits in Ohio financial institutions are taxed at the source at a rate of 2 mills on the dollar. Although the bank is authorized to deduct the tax from the deposits, in actual practice the tax is absorbed by all financial institutions. Money and credits are subject to a 2 mill rate. Credits include current accounts and prepaid items and represent the excess of current accounts receivable over accounts payable. Shares of stock of financial institutions which include banks, trust companies, and loan companies are taxed at the rate of 2 mills on the dollar of book value. Stocks in domestic insurance companies are exempt from the intangible tax but insurance companies pay a tax at the

² See Page's Ohio General Code, Annotated, Sections 5323 to 5638.

rate of 0.2 per cent on either their capital and surplus, or $8\frac{1}{3}$ times their gross premiums.

Administration of the Tax. Administration of the tax on intangible personalty is divided between state and county officials, but responsibility for assessment is definitely placed in the State Tax Commissioner. This division of administration between state and county officials has proved inefficient and should be replaced by the elimination of any assessment by county officials. The Tax Commissioner has available sources of information for checking the intangible property tax return. One of these is the federal income tax returns and another is the statements filed by corporations. Each domestic corporation and each foreign corporation doing business in Ohio is required to file an annual statement of its shareholders and the shareholders of affiliated corporations who reside in Ohio, with their place of residence and the number of shares held by each. The State Tax Commissioner also receives from the clerk of each court a statement showing each person in charge of any estate in such court, together with the aggregate value of each class of property in the estate. The Commissioner also receives from the probate courts a copy of the inventory of each estate filed.

The use of this information-at-the-source device has greatly expanded the completeness of the assessment and together with the collection-at-the-source as applied to bank deposits and shares in financial institutions presents a model plan of administration and leaves little doubt as to the possible efficacy of this type of tax.

Appraisal of the Ohio System of Taxation of Intangibles

An appraisal of the effect of Ohio's system of taxation of intangible personal property is difficult but certain conclusions can be drawn from the available data.

Appraisal of the Theory of the Ohio System. Ohio has recognized the impossibility of taxing all property, tangible and intangible, at the same rate. It has overcome the stubborn resistance to proposals to modify the general property tax. In the absence of a state income tax, Ohio has made an honest effort to treat all property as equitably as possible.

One criticism has been levied at the system of classifying intangibles into productive and nonproductive property. This device is to adjust the tax according to the relative taxpaying capacity—the rate on productive investments being five per cent of yield and on non-productive investments, two mills on market value of the property.

Professor Harley L. Lutz has criticized this classification as follows:

In fact, there is but little differentiation for the tax on \$1,000 worth of non dividend stocks would be \$2.00, while that on a \$1,000 bond yielding four per cent interest would be \$2.00. Further, bank stocks and bank deposits are alike taxable at two mills on the dollar, while moneys and credits and all other intangibles are taxed at three mills. Such a scheme is over-elaborate, and hence unnecessarily confusing both to the taxpayer and the administrator. A three-mill rate on all intangibles, such as is found in Minnesota and Maryland would have been far simpler, much less complicated in operation and no doubt fully as productive as the

existing plan, which strives vainly after careful distinctions.³

This criticism is not sound. The opinion of many of the tax administrators in the State of Ohio indicates that the classification has not been confusing. On the contrary, they report that many taxpayers have listed intangibles because the taxpayers thought that the classification brought equitable burdens. These tax officials further pointed out that the possibility of checking income-producing intangibles with personal income tax returns has greatly increased the productiveness of the tax. Further, it is difficult to determine the value of some intangibles, such as stocks not listed on the market, and hence it is more feasible to tax their income yield.

A sample survey of taxpayers made by the author indicated the general satisfaction with the present classification. Not one taxpayer objected to the tax because of an excessively complicated classification, and the great majority were of the opinion that a property tax measured by income is preferable to an ad valorem tax.

Therefore, it is concluded that, in the absence of a state income tax, the Ohio system of taxation of intangibles is superior in theory to taxation of all property at a uniform rate and to a single tax at a low rate on all intangibles.

The Effect of the Ohio System on Broadening the Tax Base. The classified personal property tax went into effect in Ohio in 1932. One of the primary purposes of the Classification Act of 1931 was to secure a greater return of personal property, especially intangible personalty.

³ Lutz, *op. cit.*, p. 390.

Table 1 clearly indicates that there has been a considerable broadening of the tax base and a spread of the tax burden over several billion dollars of intangibles which previously remained untaxed. The assessed value of tangible property fell as was to be expected in depression years, and it is only in recent years that the value of tangible personalty has exceeded that of preclassification years. These data, however, do not indicate the completeness of the assessment of intangibles in Ohio.

The Completeness of Assessment of Intangibles in Ohio. It would be extremely difficult to determine an accurate measure of the completeness of the assessment of intangibles in Ohio. Some measures however, can be secured. A study was made of the intangibles of estates up for probate in the probate courts in five counties in Ohio. The intangibles listed for probate were checked with the last personal property return made by the decedent. It was found that 63.36 per cent of the intangible personal property subject to return by the decedent was accurately reported for taxation. This figure may be higher if allowance is made for the fact that some of the productive intangibles may have been purchased in the year of the death of the decedent, in which event the income from them would not be subject to taxation until the following calendar year. It was interesting to find that the higher the value of intangibles, the more complete was the reporting of the personalty for taxation. Of over 200 estates studied, there was only one case in which no intangible personal property tax return had been made by the decedent. This sample, although comparatively small,

indicates that the assessment of intangible property in Ohio represents a percentage completeness that has never been reported by any other method of taxation of such property.

Another attempt to test the completeness of assessment in Ohio was made in 1939 by Robert S. Ford and William B. Wood. They computed the ratio of the assessed valuation of all intangibles to the sum of deposits and

179 per cent.⁴

Both of these studies provide a valid basis for concluding that the assessment of intangibles is more complete under classification than under the previous method. It must, however, be also concluded that the record is not good enough, and further efforts should be made to reduce the evasion of the tax. Along these lines, if all taxpayers were required to file a copy of their federal

TABLE 1

ASSESSED VALUATION OF VARIOUS CLASSES OF PROPERTY IN OHIO,
SELECTED YEARS

Year	Real Estate and Public Utility Property		Tangible Personal Property		Intangible Personal Property *	
	Value in Millions	Per cent of Total Assessment	Value in Millions	Per cent of Total Assessment	Value in Millions	Per cent of Total Assessment
1930	\$11,030	81.9	\$1,556	11.3	\$ 867	6.8
1931	10,004	100.0	.... †	...	7,174	41.7
1932	9,156	53.2	876	5.1	5,585	39.0
1933	8,072	56.1	710	4.9	4,983	36.5
1934	7,995	58.5	754	5.6	5,302	37.7
1935	7,930	56.7	989	6.1	6,863	42.6
1940	8,287	51.3	2,597	12.2	8,783	41.4
1947	9,848	46.4				

* The reported income from productive investments was capitalized at 6 per cent to get the value figure.

† Personal property abstract for 1931 was annulled by Ohio Amended Senate Bill no. 323.

Source: *Annual Reports of the Ohio Tax Commission* through 1935 and Reports of Department of Taxation thereafter.

mortgages. Prior to classification, this ratio did not exceed 41 per cent and in four years the assessed valuation was less than 30 per cent of the total mortgages and deposits. These figures indicated a high incompleteness of assessment prior to classification.

After the adoption of the classified plan, the study showed that the assessed valuation of all intangibles was substantially greater than the amount of mortgages and deposits in Ohio. From 1932 to 1936, the percentage of assessed valuation of all intangibles to mortgages and deposits ranged from 373 per cent to

income tax return with their intangible personal property tax return, there should be an increase in the percentage of intangibles listed for tax purposes. Further, the personnel of the Personal Property Tax Division of the Department of Taxation should be expanded so as to insure a more accurate and comprehensive audit. With these changes in the administration of the intangible tax, the completeness of assessment should approximate 100 per cent.

⁴ Robert S. Ford and William B. Wood, *Taxation of Intangibles in Michigan* (Ann Arbor: University of Michigan Press, 1939).

Effect of Classification upon Tax Levy on Intangibles. No further attempt was made to study the effect of classification upon the tax levy on intangibles than that made by Mr. Ford and Mr. Wood. These men concluded that "although the actual levy on intangibles was lower in the years after 1932 than in 1930, it was higher in the new system than it would have been under the old."⁵

property tax from real estate to other types of property.⁶

A study of the tax levies on different types of property, as shown in Tables 2 and 3, should give some indication of the respective burdens of taxation on different classes of property.

The data of these tables seem to disprove the conclusion reached by Professors Thewlis and Falconer. For 1932,

TABLE 2
TAXES LEVIED ON VARIOUS CLASSES OF PROPERTY IN OHIO,
SELECTED YEARS

Year	Real Estate and Public Utility Property *		Tangible Personal Property		Intangible Personal Property		Total in Millions
	Taxes in Millions	Per cent of Total Taxes	Taxes in Millions	Per cent of Total Taxes	Taxes in Millions	Per cent of Total Taxes	
1930	\$286	81.9	\$39	11.3	\$23	6.7	\$348
1931	222	85.2	20	7.7	19	7.1	261
1932	201	86.9	16	7.0	14	6.1	231
1933	181	86.5	16	7.6	12	5.9	209
1934	150	83.6	15	8.3	15	8.1	180
1935	153	83.2	16	8.9	14	7.9	183
1940	162	79.7	22	10.9	19	9.4	203
1946	190	72.8	41	15.7	30	11.5	261

* Special assessments are not included.

Source: *Annual Report of the Department of Taxation, State of Ohio, 1947, p. 34.*

Relief to Real Estate. The next factor to be considered is the question of tax relief to real estate. Professors J. D. Thewlis and J. J. Falconer in a study made in 1942, concluded:

Apparently, the greater amount of personal property returned for taxation just about compensates for the lower rates on intangibles and the shift from true value to a percentage of true value as a basis for taxing tangible property. In other words, classification of property for taxation has not resulted in shifting the burden of the

the first year of the classification plan, the levy on real estate and intangibles amounted to 86.9 per cent and 6.1 per cent, respectively, of the total levy. A comparison of the levies in 1930 and 1935, shows that the relative and absolute burden on real estate had declined, while that on intangibles remained about the same. Since 1935, the relative and absolute burden on real estate has continued to decline while

⁶ J. D. Thewlis and J. J. Falconer, *Public Revenue in Ohio with Especial Reference to Rural Taxation*, Ohio Agricultural Experiment Station, Bulletin 638 (December, 1942), p. 43.

⁵ *Ibid.*, p. 16.

TABLE 3
TAXES LEVIED ON VARIOUS CLASSES OF PROPERTY IN OHIO AS
PERCENTAGE OF TAXES LEVIED IN 1930, SELECTED YEARS

Year	Real Estate and Public Utility Property	Tangible Personal Property	Intangible Personal Property	Total
1930	100.0	100.0	100.0	100.0
1931	77.8	51.0	79.4	74.9
1932	70.5	41.4	59.8	66.5
1933	63.4	40.5	52.5	60.0
1934	52.6	37.6	62.5	51.6
1935	53.4	41.5	61.9	52.6
1940	56.7	56.3	82.0	58.4
1946	66.5	103.8	128.3	74.8

Source: Computed from data in Table 2.

that on tangible personalty and intangible personalty has increased. Expressed as a percentage of taxes levied in 1930, the levy on real estate had declined from 70.5 per cent in 1932 to 56.7 per cent in 1940 and 66.5 per cent in 1946 while the levy on intangibles by 1946 had increased from 59.8 per cent in 1932 to 128.3 per cent of the 1930 levy. Although part of the decrease of the levy on real property was caused by the decline in rate following the adoption of the 10 mill rate limitation in 1934, it must nevertheless be concluded that the Ohio system of classification has substantially reduced the tax burden on real estate since its adoption.

Conclusions

There is no doubt that the taxation of intangible personal property has accumulated more confusion, incompetency, and dishonesty than any other tax in our system of taxation. Because of the theoretical considerations of resulting double taxation and the administrative problem of wholesale evasion, the only consistent course for those who desire the substance of uniformity and

equality would seem to be to exempt intangibles from the general property tax. This does not mean that they should be exempt from all taxation. The income from intangibles should be taxed under a general income tax. Failing this, the next most rational course would be classification.

This is the situation in Ohio. Although the constitution permits a state income tax, as long as the assembly is controlled by rural areas the chance that a general income tax will be enacted is small. In other states which do not levy an income tax, it is recommended that the Ohio system be given careful consideration.

The classification in Ohio is sound in theory, and tax administrators and taxpayers generally feel that the tax is equitable and that it is being uniformly administered. The Ohio system has spread the tax burden over several billion dollars of intangibles which previously remained untaxed, thus broadening the tax base. Several bank officials have stated that prior to classification, a large amount of trust business was lost to New York where no

property tax is levied. Since the adoption of the classified tax by Ohio, there has been little trust business lost to other states because of taxation and some of the trusts that had been established in New York to avoid the Ohio general property tax were revoked and put in the hands of Ohio trust companies.

A sample study made of the completeness of assessment of intangibles indicates that a relatively high percentage, 63.36 per cent in our sample, is being reported. The Ohio system has further resulted in reducing the

burden on real estate which in most states is bearing too heavy a load, increasing, in turn, the rate of delinquency.

In administration, the Ohio system again provides a model of collection-at-the-source and information-at-the-source which is necessary for effective administration of any low-rate tax on intangible personal property.

Consideration of such facts leads to the conclusion that the Ohio system represents a successful experiment in the taxation of intangible personalty.

INEQUALITIES OF RESIDENTIAL PROPERTY TAXATION IN METROPOLITAN BOSTON

ROSWELL G. TOWNSEND *

ALTHOUGH it is generally recognized that the burden of real property taxation falls unfairly on various property owners, case studies of the nature and extent of inequalities are not numerous.¹ In this study of the metropolitan area of Boston, two particular kinds of inequalities are considered: (1) inequalities of taxation within cities comprising metropolitan Boston, and (2) inequalities between these cities. The desirability of tax equalization is discussed in each case, and it will be suggested that some improvement in the equity of real property taxation could be realized by utilizing data which are available concerning assessments and selling prices.

About 1,500 residential property sales covering the period from October 1 to November 12, 1947, for the counties of Middlesex, Suffolk, and Norfolk were analyzed.² The properties were sorted by communities and

by one-, two-, and three-family (City of Boston only) houses. Assessment-to-sales ratios were then calculated for each property.

I. Inequalities within Metropolitan Boston

Massachusetts law states that the tax assessment value shall be the fair cash value³ and shall be proportional for all properties.⁴ Assessment - to - sales ratios considerably below 100 per cent represent a lag of assessment behind a rising market but this in itself is not a matter of great concern.⁵ However, inequalities in the assessment-to-sales ratios represent an unjust levy of the tax regardless of the price level.

Table 1 presents assessment-to-sales ratios for single houses. Differences among cities will be considered below. Column 4, the percentage of assessment-to-sales, dollar weights, expressed on a

* The author is associate professor of economics at Wilson College in Chambersburg, Pennsylvania.

¹ I am indebted to Mr. William Loring and the Housing Association of Metropolitan Boston for assistance in carrying out this study. A fuller discussion of the data and their meaning may be found in *Some Economic Aspects of Urban Housing with Special Reference to Metropolitan Boston*, unpublished doctoral dissertation, Harvard University Library, 1948.

² This information was made available through the courtesy of the Metropolitan Mortgage Bureau, Inc. The information is available on cards which give selling price, assessment, date of sale, location, and type of property. Sales prices are secured from the revenue stamps on the deed. The Bureau, however, verifies selling prices and assessments when possible.

³ See Philip Nichols, *Taxation in Massachusetts*, 3d ed. (Boston, 1938), pp. 303 ff., especially p. 306: "The law is however clear. It does not recognize any such test as 'normal value.' Periods of great general business depression (or general prosperity) actually affecting the cash which in exchange for the property a willing buyer would give and a willing seller take . . . covering a measurably substantial time, must be regarded by the assessors and reflected in the assessed valuation."

⁴ *Ibid.*, pp. 112, 113.

⁵ It does result, of course, in higher tax rates, but on a lower base. Consistent assessments of less than market values do greatly complicate relief for an overassessed taxpayer, since neither he nor the assessor knows the correct assessment-to-sales ratio to be used. Nor can such a ratio, if known, be justified legally.

ratio of the same percentage, equal weights, provides a measure of fairness of the assessment practices within each jurisdiction.⁶ A figure considerably above 100 shows that high-priced houses have been assessed at a high ratio whereas a figure less than 100 indicates that low-priced houses have been assessed heavily. Table 1 suggests, therefore, that assessors ease up on the more

houses and for the City of Boston by breaking down the properties according to selling prices and giving the assessment-to-sales ratio for houses falling in different value ranges. Both the number of cases and the ratios are provided. It is clear that in late 1947 the assessment valuations were relatively high on poor properties, low on middle and fairly substantial properties, and a bit

TABLE 1
PERCENTAGES OF ASSESSMENTS-TO-SALES PRICE FOR SINGLE HOUSES,
REPORTED FOR OCTOBER 1 TO NOVEMBER 12, 1947

City	1 Number in Sample	2 Assessment to Sales, Dollar Weights	3 Assessment to Sales, Equal Weights	4 Ratio-Column 2 to 3
Arlington	54	46.8%	46.9%	100
Belmont	29	51.6	53.4	97
Boston	163	54.5	63.0	86
Braintree	38	48.2	48.0	100
Brookline	28	62.2	62.0	100
Cambridge ...	39	60.7	64.5	94
Dedham	25	58.6	54.9	107
Lexington	24	54.4	54.5	100
Malden	30	54.2	55.6	97
Medford	55	61.2	62.4	98
Melrose	32	49.9	50.2	99
Milton	14	47.0	43.9	107
Needham	23	48.4	49.5	98
Newton	108	54.0	55.4	98
Quincy	111	56.5	56.6	100
Stoneham	18	54.0	54.6	99
Waltham	28	47.6	48.1	99
Wellesley	35	47.5	48.0	99
Winchester ...	25	68.0	73.7	92
Winthrop	20	61.4	63.6	97

expensive properties in Boston, Cambridge, and possibly Winchester (the sample is small for Winchester), whereas these properties appear to be relatively overassessed in Milton and Dedham (but again the sample is very small).

Table 2 develops the inequality of assessment practice for suburban single

higher on expensive houses. These valuations may represent failure of the assessors to keep up with the sharply rising prices of medium-priced houses. Periodic analyses of assessment-to-sales ratios could provide the assessors with a means of preventing inequalities which vary consistently according to the value of the taxable properties.

Still another statistical measure is available as a test of the adequacy of the assessment practice. If assessments were perfect and all sales represented the true market value of the property, a

⁶ Column 2 was secured by totaling the assessments and the sales prices for all sample cases in each city and then by finding the aggregate assessment to aggregate sales ratio. This procedure gives a heavier weight to more expensive houses. Column 3 represents an arithmetic average of the assessment-to-sales ratio calculated separately for each property.

perfectly uniform assessment-to-sales ratio would exist. But of course the assessment practice is not perfect nor do market sales represent a unique value of the property. If, however, a study were made of the deviations from the

Table 3 shows the average deviation from the assessment-to-sales ratio for the City of Boston and for three suburban areas. The relative deviation from the mean shows the relationship between the average deviation of the as-

TABLE 2

BOSTON AND SUBURBAN HOUSES

FREQUENCY DISTRIBUTIONS OF SALES PRICES AND AVERAGE ASSESSMENT-TO-SALES PERCENTAGES, BY SALES PRICE AND TYPE HOUSES,
OCTOBER 1 TO NOVEMBER 12, 1947

Sales Price	Suburban Singles		Boston Singles		Suburban Two-Family		Boston Two-Family		Boston Three-Family	
	Num-ber	Per-cent	Num-ber	Per-cent	Num-ber	Per-cent	Num-ber	Per-cent	Num-ber	Per-cent
\$ 0-\$ 3,999	14	73	21	84	..	..	..	..	..	..
4,000- 4,999	20	63	23	73	22	92	32	82	39	92
5,000- 5,999	22	68	..	..	..	..	..	..	..	..
6,000- 6,999	37	61	16	71	..	..	..	..	..	..
7,000- 7,999	57	60	38	61	7	70	25	73	55	87
8,000- 8,999	63	58	18	67	..	..	..	..	..	..
9,000- 9,999	71	55	21	54	25	69	..	..	..	..
10,000- 10,999	73	54	18	65	39	62	38	74	..	..
11,000- 11,999	57	52	25	51	30	61	..	..	..	..
12,000- 12,999	57	55	17	61	9	59	23	61	18	69
13,000- 13,999	53	52	15	64	..	..	..	..	..	..
14,000- 14,999	40	50	7	50	12	60	..	..	..	..
15,000- 15,999	41	50	..	..	8	58	..	..	..	..
16,000- 16,999	37	50	..	..	..	..	..	..	..	..
17,000- 17,999	17	51	..	..	..	..	..	..	..	..
18,000- 18,999	20	54	6	65	16	58	9	60	5	82
19,000- 19,999	..	..	..	..	..	..	..	..	..	..
20,000- 20,999	19	53	..	..	..	..	..	..	..	..
21,000- 25,999	30	54	9	66	..	..	..	..	..	..
26,000- 30,999	17	58	..	..	..	..	..	..	..	..
Over 31,000	13	55	..	..	..	..	..	..	..	..

NOTE: Five extreme items omitted in averaging items within sales classes. The location of the figures indicates the different class intervals for the five distributions.

average assessment-to-sales ratio for one city, compared with others, the market variations of actual sales prices from some "true" value might be assumed to be the same or at least similar. If a striking lack of uniformity characterized one city, compared with others, this should be attributed to differences in the efficiency of the assessment practice.

assessments divided by the average assessment-to-sales ratio. The City of Boston shows a much greater lack of uniformity in the individual property assessments (an average 30.5 per cent variation) compared with suburban assessments (about 18 to 19 per cent variation).⁷ The explanation of this

⁷ In passing it may be noted that the heterogeneous suburban homes are more difficult to assess than the more homogeneous Boston residential properties.

inefficiency of the assessment process in the City of Boston may lie in the quality of the assessors, the ward system, the process of assessment itself, or perhaps other factors not readily apparent. Statistical tests such as Table 3 may provide a check for each city as to the efficiency of the assessment process.

capitalized, however, only when (1) a sale occurs after the unfair assessment is imposed (or expected to be imposed), (2) when the unfair assessment is expected to continue, (3) when the buyers are aware of the fact that the assessment is unfair, and finally (4) only when economic account is taken of the fact that a high assessment lowers

TABLE 3
AVERAGE DEVIATION OF ASSESSMENT-TO-SALES PERCENTAGES
BOSTON AND THREE SUBURBAN GROUPS
SINGLE HOUSES

City	Number in Sample	Average Assessment	Average Deviation	Relative Deviation from Mean
		Per cent	Per cent	Per cent
Boston	163	63	19.2	30.5
Suburban I*	142	63.1	11.4	18.1
Suburban II*	345	55.5	10.0	18.0
Suburban III*	224	47.9	9.2	19.3

Group I includes Brookline, Cambridge, Medford, and Winthrop.

Group II includes Belmont, Dedham, Lexington, Malden, Newton, Quincy, and Stoneham.

Group III includes Arlington, Braintree, Melrose, Milton, Needham, Waltham, and Wellesley.

* These groups represent high, medium and low assessment-to-sales percentages.

NOTE: An adjustment has been made in Group III for the very low average assessment in Milton.

II. Desirability of Equalization

Tables 1, 2, and 3 suggest the need for fairer assessments between individual properties, especially for the City of Boston. The tax seems to fall more heavily on cheap houses and on two- and three-family houses. A presumption is established that equalization of the rates is desirable. This may be countered with the argument that once inequalities are established, they are capitalized when properties are transferred. Equalization would then provide a bonus to the owner of highly taxed property and a penalty to the owner of a property bearing a low assessment. An unequal tax assessment is

value.

To indicate the conditions required for capitalization of unequal assessments is at once a criticism of the doctrine, for it seems apparent that for single homes especially, and to some extent for two- and three-family homes, these conditions are not generally fulfilled. Taking the conditions in order we find: (1) No data are available as to the proportion of properties sold after an unfair assessment is levied, or the assessment becomes unfair by changes in market values, but it might not constitute half of all properties. (2) If the assessment is *obviously* unfair, an abatement or new assessment may be

secured. Moreover, an unfair assessment is not a permanent thing. Assessments do change, and so do the values of the properties themselves. (3) Buyers may not be aware that an assessment is unfair, particularly when assessments diverge from fair cash value. Even professional real-estate dealers and bankers have only rough notions from personal experience of the normal assessment ratio. (4) It is at least possible

in cases in which the assessment has not been capitalized.⁸

III. Inequalities among Cities in Metropolitan Boston

Table 4 lists the assessment-to-sales ratios (based on equal weights) from Table 1 and the 1947 tax rates. By multiplying the actual tax rate by the assessment-to-sales ratio for each city, a true rate of taxation is secured, as in

TABLE 4

SINGLE HOUSES BOSTON AND SELECTED SUBURBAN TOWNS
CALCULATION OF TRUE RATE OF TAXATION AND AVERAGE TRUE RATE PER SINGLE HOUSE

City	Number Sample	Per cent Assessment (Equal weights)	1947 Tax Rate	True Rate
Arlington	54	46.9	\$42.80	\$20.10
Belmont	29	53.4	31.00	16.60
Brookline	28	62.0	33.70	20.90
Cambridge	39	64.5	35.50	22.90
Dedham	25	54.9	35.00	19.20
Lexington	24	54.5	36.00	19.60
Malden	30	55.6	44.60	24.80
Medford	55	62.4	42.00	26.20
Melrose	32	50.2	36.40	18.30
Milton	14	43.9	33.50	14.70
Needham	23	49.5	31.50	15.60
Newton	108	55.4	32.00	17.70
Quincy	111	56.6	33.00	18.70
Waltham	28	48.1	42.20	20.30
Wellesley	35	48.0	31.00	14.90
Winchester	25	73.7	32.80	24.20
Winthrop	20	63.6	39.00	23.50
Boston	163	63.0	46.50	29.30

that in some cases a high or low assessment is taken by both buyers and sellers, or the duped buyer or seller as the case may be, as an indication of true value. To the extent that this is so, capitalization is reversed.

While it is certainly true that some unfair assessments might have been capitalized and equalization would then provide a windfall gain or loss to the present owner, there seems to be more evidence that equalization would correct a far greater number of injustices

column 4 of Table 4. In general, this true rate has a negative correlation with the economic level of the city: the wealthier the city the lower the true rate of taxation. Boston itself is strikingly higher than the surrounding cities. If an average for single houses is taken of all cities in Table 4, except Boston (weighted by number of dwelling units), the suburban tax rate would be

⁸ Moreover, assessments and market values do change, though sometimes slowly. It would be a complicated and difficult task for the assessors to preserve the inequalities to avoid injustice.

\$19.50 per thousand dollars of market value, whereas the rate of \$29.50 for the City of Boston is about 50 per cent higher. The Boston rate is about 100 per cent higher than Wellesley.

Table 5 reveals the true rate of taxation for two-family houses in certain suburban cities and for both two- and three-family houses in the City of Boston. It is again apparent that in

ideally an equalization of rates between cities would be desirable.⁹ When wealthier families congregate in newer suburban communities service costs are less and the tax base is larger. Hence the rate of taxation, especially the *ad valorem* rate, is less than for centrally located poorer communities. The movement to the suburbs is in part prompted by a desire to evade property taxation

TABLE 5
SUBURBAN TWO-FAMILY HOUSES
BOSTON TWO- AND THREE-FAMILY HOUSES
CALCULATION OF TRUE RATE OF TAXATION AND AVERAGE TRUE RATE PER PROPERTY

City	Number Sample	Per cent Assessment (Equal weights)	1947 Tax Rate	True Rate
Arlington	23	57.4	\$42.80	\$24.60
Belmont	19	64.2	31.00	19.90
Brookline	8	68.8	33.70	23.20
Cambridge	12	88.4	35.50	31.40
Malden	16	68.1	44.60	30.40
Medford	20	70.6	42.00	30.00
Melrose	11	63.6	36.40	23.20
Newton	9	60.2	32.00	19.30
Quincy	15	71.9	33.00	23.70
Somerville	88	69.8	42.90	30.60
Waltham	15	68.1	42.20	28.70
Watertown	27	64.7	39.10	25.30
Boston Two-Family .	128	68.6	46.50	31.90
Boston Three-Family	155	82.1	46.50	38.20

general, the true rate of taxation is lower, the wealthier the city, although the correlation is certainly not so good as for single homes. If an average of two-family homes were taken for all cities except Boston (weighted by number of houses), the true rate would be \$27.50 for these cities compared with \$31.90 for Boston. The Boston rate was 17 per cent higher than the suburban two-family rate.

IV. Desirability of Equalization

Tables 4 and 5, since they show inequality in the true rates of taxation for different towns, seem to suggest that

and the burden of servicing poorer families. Since the suburban communities are separately incorporated, it is easy to escape the higher rates in the urban areas, leaving these areas with poorer taxpayers and a greater service burden.¹⁰ The view that differentials

⁹ The differentials may not be so great as the figures indicate since suburban communities may offer fewer services for the lower rates. Moreover, it is only differentials in the *onerous* rates which should be considered; in so far as the higher-rated community offers an added service, the statistical differential may not be a true differential.

¹⁰ Alfred Marshall restated his testimony before the Royal Commission as follows: "For permanent inequalities of onerous rates, though considerable, are less than is commonly thought; and many of them

should be equalized has been accepted by Victor Jones and Paul Studenski.¹¹

Although a good case may be made for the unfairness of permitting such differentials originally, once the differentials have become established, it is by no means clear that equalization is desirable. Henry A. Simon has taken the position that equalization of tax differentials is undesirable.¹² The argument in general is that the differentials are capitalized; therefore, any equalization between communities would effect a hardship on the owners in the low-rate communities and provide a windfall gain for owners in the high-rate communities. Once differentials come into existence, it is fairer to leave them undisturbed, if it is politically possible. The objective, instead, should be to equalize services, since service differentials are not capitalized to the

extent that tax differentials are capitalized.¹³

The reasoning underlying the argument that tax differentials are capitalized follows. Since a tax can be capitalized only when the burden rests on the owner, capitalization of the differentials must occur through changes in site values.¹⁴ Since this is so, the low tax rate areas should be capitalized in the form of high site values and *vice versa*.¹⁵ In equilibrium, these values are so adjusted that returns are equal in both areas, despite the tax differential. Hence, "it may be concluded that an unanticipated increase or decrease in tax rates will work a hardship or present a windfall, as the case may be, to the owners of property who are subject to the tax."¹⁶ Simon summarizes: "If there is any inequity in the way in which property taxes are distributed, that inequity becomes, through the exchange of property, an historical one, irremediable by a change in tax rates. We showed that it is highly probable that the larger part of the tax differentials among different cities within a metropolitan area are capitalized. If this is true, tax equity would not be furthered by the abolition of tax differentials in a metropolitan area."¹⁷

Not all the links in this chain of reasoning are strong enough to draw the conclusion as firmly as Simon does.

¹³ Simon, *op. cit.*, pp. 3-6.

¹⁴ That is, in general, the values of improvements are determined by costs of new construction and hence differing rates of taxation cannot affect these values.

¹⁵ Simon does not seem to include this phase of the argument, but it is at least implied.

¹⁶ Simon, *op. cit.*, p. 19.

¹⁷ *Ibid.*, p. 23.

¹¹ Victor Jones, *Metropolitan Government* (Chicago, 1942), pp. 72-79, and Paul Studenski, *The Government of Metropolitan Areas in the United States* (New York, 1930), pp. 37-41, from Henry A. Simon, *Fiscal Aspects of Metropolitan Consolidation* (Berkeley, 1943), p. 23.

¹² *Fiscal Aspects of Metropolitan Consolidation*, *ibid.* This view was also expressed in 1899 before the Royal Commission of Local Taxation. See, e.g., the view of Prof. Sedgwick, *Memoranda Chiefly Relating to the Classification and Incidence of Local Taxation* (London, 1899), p. 104.

These weak links are as follows:

1. Simon assumes, in the main argument, that service differentials are capitalized less than are tax differentials. No evidence is presented for this. But people *do* consider the relative values of school and other municipal services in purchasing or renting a home. Moreover, many home purchasers entirely neglect tax differentials. There seems to be no particular reason, then, for the assumption that service differentials are capitalized less than are tax differentials.

2. Capitalization can occur only when property is sold. No statistics are presented, nor is any evidence suggested as to what proportion of properties is sold.¹⁸

3. There is an implicit assumption in Simon's reasoning that the supply of land is not elastic in either tax area. Changes in demand for sites are assumed to drive up site values to the extent of the tax advantage, and to lower values in the high-tax area. But if the supply of land is elastic in the low-tax area, then the price of sites cannot be driven up very much and, hence, capitalization of the lower rates cannot occur.¹⁹ New purchasers may always, in this case, get a house and land for about the same price, regardless of tax differentials, and hence enjoy the lower tax rate. Equalization would not, then, place an extra burden on the low tax-

rate areas, but simply correct an injustice.

The Simon presentation of the case for capitalization of the differential tax rate in the suburban lower-rate area seems to rest in part on inelasticity of the supply of land for residential purposes. The usual metropolitan area (and this is certainly true for Boston) consists of a central built-up high-rate city or cities and a number of suburban towns with lower rates. For the central area, land appears to be inelastic in supply. But for suburban low-tax-rate areas, residential land appears in fact to be very elastic, primarily as a result of the general use of the automobile. In Boston, at least, residential land in suburban areas is abundant and lots are plentiful at reasonable prices. A study made by the State Planning Board of the Commonwealth of Massachusetts in 1946 of the availability of land for residential use, though not considering the question of price, showed that in 109 zoned communities alone enough land is available to build 1,581,600 new dwelling units, or more than enough land to rehouse the entire state.²⁰ It would be difficult to argue for Boston, and it seems true of most metropolitan areas, that the lower suburban tax rate was capitalized in a higher initial site value and, therefore, that equalization of the rate would be unfair to suburban owners.

Nevertheless, the tax differential does result in lower values in the central areas and this is particularly so when new houses are not being built or when existing houses are not close substitutes for new houses. In these cases, higher

¹⁸ It may be further pointed out that where a man sells one home to buy another, in the same tax jurisdiction, the effect is as though no sale transpired. Only *new* purchasers of homes in a given district stand to gain or lose by equalization.

¹⁹ A reminder is again made that if new houses are built at all, then the value of the house itself is governed by construction costs and cannot be capitalized. The capitalization argument here must rest on changes in site value alone.

²⁰ *Report on Residential Area Survey* (Boston, 1946), p. 10.

taxes reduce net incomes and hence values. An added effect of the differential is to shift the use of housing from the high-rate to the suburban areas, since annual suburban housing costs are cheaper, thus further reducing the rents and values of urban housing.²¹ In so far as the *urban* houses have changed hands, then, equalization of the rates would cause windfall profits to accrue to present owners.

The fairness of equalization of tax rates between metropolitan communities is, therefore, not clear. A sudden equalization seems not desirable, but steps to prevent the differential from increasing and probably some gradual steps toward equalization would seem to be justified.

²¹ The tax differential does not, however, raise the values of suburban housing in the long run since new houses can be built on low-cost land. Since the short-run supply conditions of new construction are inelastic, a sudden increase of the differential would raise costs and prices of suburban houses.

V. Conclusion

The analysis of assessment-to-sales ratios of residential properties in metropolitan Boston shows substantial inequality of assessments depending on the value of the property. These ratios could be used to make corrections in the assessments, and this equalization seems clearly to be desirable. Examination of these ratios also shows that assessments are more unfair to individual property owners in the City of Boston than in suburban areas. Statistical analysis of assessment-to-sales ratios can provide a check on the adequacy of assessment practices.

The study of true rates of taxation reveals that wealthier suburban communities are taxed less than are poorer central ones. Consideration of the process of capitalization suggests that this inequality should, if possible, be gradually removed.

FRINGE GROWTH AND TAX RATES

ROBERT C. SCHMITT *

WHAT EFFECT does the existence of a large fringe population have on the tax rate of the central city? This question has considerable bearing on annexation policy. The exact answer will vary in specific instances, but some general conclusions are possible through analysis of available data.

The table given below is based on information recently published on city tax rates¹ and the population of "urbanized areas."² Each of twenty central cities with extensive fringe areas was matched with a comparable city in the same state having little or no fringe population.³ It was thus possible to

hold many geographical and political factors constant. The same matched cities were used to compare assessed valuation per capita. Both tax rates and assessed valuations were adjusted to current market value, since many cities assess property at less than full value. The unweighted averages for each group of twenty cities and the statistical significance of their differences are summarized in the accompanying table.

There was little actual difference in 1950 between the average adjusted tax rate of the twenty cities with populous fringe areas and the twenty with little or no fringe population. In fact, another sample of the same number of matched cities might well reveal no difference at all. It would thus appear that a cordon of unannexed communities makes for no higher tax rates in the central city than does the absorption of peripheral growth implied in the data for the second group.

Trend data reveal distinct differences between the two groups. Since 1945, rates for central cities with dense fringe areas have declined almost 10 per cent when adjusted to current market value.⁴ The group with little or no fringe population, on the other hand, had an average increase of 7.5 per cent.

⁴ Adjusted rates for 1945 were taken from The Volker Fellows, "Tax Rates of American Cities," *National Municipal Review*, XXXIV (December, 1945), pp. 547-566.

* The author is chief of research for the Seattle City Planning Commission.

¹ Bureau of Governmental Research (Detroit), "Tax Rates of American Cities," *National Municipal Review*, XL (January, 1951), pp. 17-38.

² U. S. Bureau of the Census, "Population of Urbanized Areas: April 1, 1950," *1950 Census of Population—Preliminary Counts*, Series PC-3, No. 9 (February 1, 1951). "An urbanized area consists of one or more cities of 50,000 or more and all the nearby closely settled suburban territory, or urban fringe."

³ The paired cities were: Mobile and Montgomery, Alabama; San Bernardino and Fresno, California; Bridgeport and Waterbury, Connecticut; Tampa and Jacksonville, Orlando and St. Petersburg, Florida; Rockford and Decatur, Peoria and Springfield, Illinois; South Bend and Fort Wayne, Indiana; Waterloo and Sioux City, Iowa; Brockton and Lowell, Massachusetts; Lansing and Flint, Kalamazoo and Saginaw, Muskegon and Pontiac, Michigan; Binghamton and Utica, Schenectady and Niagara Falls, New York; Dayton and Toledo, Ohio; Johnstown and Lancaster, Reading and Altoona, Pennsylvania; Nashville and Memphis, Tennessee; and Port Arthur and Beaumont, Texas.

Not unexpectedly, adjusted assessed valuation per capita was found to be lower in the cities with little fringe population. By annexing the low density, predominantly residential land on their outskirts, they had appreciably lowered their over-all average per capita.

These figures suggest that annexation is no financial panacea for cities. From one point of view, the twenty cities

10.7 square mile residential area, was likely to cause expenses far in excess of returns for a number of years. The other, a 214 acre tract heavily built with industrial plants, promised immediate high return relative to cost. Continued absorption of areas of the first kind would probably lead to the need for a higher city tax rate. The reverse would be true if the city annexed only valuable industrial land.

CHARACTERISTICS OF 40 MATCHED CITIES: 1950

Characteristic	Unweighted average		Critical ratio *
	20 cities with large fringe population	20 cities with little fringe population	
Urbanized area population	146,400	143,000	...
Per cent population in central city	67.9	87.6	...
Tax rate †	\$25.22	\$26.94	1.55
Tax rate trend since 1945 †	-9.6%	+7.5%	2.90
Assessed valuation per capita †	\$1,775	\$1,562	2.89

* A measure of sampling reliability. A ratio of 1.55 indicates a greater than 10 per cent probability that the observed difference is due to chance sampling variation. Ratios of 2.89 or more indicate less than 1 per cent probability.

† Adjusted to current market value.

with little fringe growth may be regarded as an annexing group; the cities with large fringe populations, conversely, may be considered as a non-annexing group. It is significant that tax rates are, if anything, more favorable in the nonannexing cities. Municipal governments should not expect an uncritically applied pro-annexation policy to produce improved tax rates.

Specific cases may not conform to this general conclusion. Late in 1951, the City of Seattle was considering two major annexations. One, a sparsely settled

Furthermore, the effect of annexations on tax rates is only a small part of the broader problem. Annexation policy should be based on many different considerations—the socio-economic unity of the central city and fringe, inefficiency resulting from duplicated personnel and facilities, and similar questions. It is true that a heavy fringe growth does not appreciably affect the tax rates of the central city. Other by-products of nonannexation may or may not be desirable.

BOOK REVIEWS

The Illinois State Budget for the Biennium July 1, 1951 to June 30, 1953, and Services and Costs: 1950. By DEPARTMENT OF FINANCE, State of Illinois. Springfield, Illinois, 1951. Pp. 499 and 61.

It may seem odd for the printed budget of a state government to be noted in the book review section of the *National Tax Journal*. After all, budget documents are issued annually by a number of states and biennially, in one form or another, by the remainder. Nearly as common are popularized state reports of the "where the money came from and where it went" variety. Yet, although the two recent Illinois publications cited above are of these familiar types, they are so unusual in actual content as to deserve attention far beyond the boundaries of Illinois. They provide much-needed examples of understandable and yet intellectually respectable presentation of information about the finances of a major government.

Perhaps the most outstanding feature of the 1951 Illinois budget is its comprehensiveness. An analysis made a few years ago by the Governments Division of the United States Bureau of the Census showed that only half of the state budgets issued in 1947 presented figures covering as much as 50 per cent of all the respective states' expenditure (even aside from unemployment compensation benefits, paid out by the states but universally excluded from budget presentations). Recent previous Illinois budgets have been better than average in this respect. They have included, for example, total revenue and expenditure amounts as to state-collected locally-shared taxes. However, the 1951 Illinois budget goes still further toward providing a really comprehensive picture of the state's income and outgo by bringing in certain significant revenue and expenditure amounts (particularly as to federal aids) which had previously been omitted.

The 1951 Illinois document also excels the average state or municipal budget in its grouping and summarization of aggregates. From the first few summary tables, even the casual reader can see comparative biennial appropriation totals from "state funds" and "federal funds"; for the four main type-of-spending categories, "operations," "aids and grants," "new capital outlay," and "debt service and tax refunds"; and, under the first three of these broad headings, totals and significant detail figures as to the eight major functional classes applied to expenditure. These summary presentations are so constructed as to reflect the existence of certain special funds and accounts. However, this necessary complication is subordinated to the primary purpose of giving an orderly over-all picture of the state's finances.

Nor is the reader—as in many instances—left with only a brief gubernatorial message and budget officer's letter of transmittal as a guide to reams of revenue and expenditure figures. The latter are provided (still in considerably more detail as to personnel and minor objects of expenditure than seems necessary for legislative action and public information), but they are supplemented by well-written textual material which gives meaning and background to the figures. The twenty-six text pages devoted to "Proposed Distributive and Capital Expenditure" describe policies and proposals in the light of past trends, economic expectations, and the like. Nine closely-printed pages explain clearly the "Revenue Outlook," and describe the basis of estimates for all significant revenue sources. (Here, incidentally, the complexities introduced by multiple funds and earmarking of revenues are nicely illustrated in a table showing the allocation into five parts of "revenue from horse racing"—which altogether makes up about 2 per cent of the state's total income.) A separate textual portion follows for each organizational unit, dealing with its nature

and current operations. In the case of relatively large units and those for which sharp changes in cost are indicated, these sections generally offer some direct background for dollar amounts presented.

No doubt an even less complex and more informative budget would be made possible in Illinois by changes in fund and organization structure, legislative habits, and appropriation patterns. Yet, since these problems and limitations are so widely found also in other states and in municipal governments, the outstanding presentation job which has nevertheless been accomplished may have even greater value as a challenge to executives and budget officers elsewhere.

Services and Costs: 1950, the other publication cited above, bears the subtitle "A Report on your Illinois State Government: Where the money came from and what it bought." The foreword warns that this is primarily a popular report and that the technician should look elsewhere for detail and technical discussion. Nevertheless, this pamphlet deals most simply and effectively with major ramifications of Illinois state finances, and shares with the 1951 Illinois Budget the unusual virtue of comprehensiveness.

Illinois expenditure is presented primarily in terms of major state functions, and then, again, in terms of "the forms of expenditure"—operations, capital costs, aids to individuals, grants to local governments, and interest on debt.

Perhaps the most striking characteristic of the text is its effectiveness in providing perspective. The role of government as a supplier of services not readily provided individually or commercially is presented clearly. Revenues and expenditures of the state are discussed in the light of historical trends; compared with financial magnitudes of other states; and related to the finances of local governments and the Federal Government.

Such background discussion generally avoids the "loading" favorable to one's own government, administration, or policies which too often impairs the objective tone of popularized financial reports. Scattered

throughout the text are striking analogies and down-to-earth examples—e.g., the demonstration on page 9 that "it costs less to buy roads than to buy parking space!" In marked contrast also to the provincial attitude sometimes found in print is the following conclusion of a treatment of Illinois revenue from "Federal Grants":

So far as Federal aids alone are concerned, Illinois in effect 'subsidized' the other states, as a group; our share in the total of Federal funds allocated as aids to state governments was less than proportionate to either our population or our contribution to the Federal Treasury. The same situation exists within the State, where we find that some localities receive back less in school aid than they pay in toward the total amount the State earmarks for distribution to school districts. . . . This simply evidences operation of the principle of equalization: taxes tend to come from those persons and areas that possess tax-paying capacity, while expenditure is made where Congress or the General Assembly determines that needs are greatest.

George W. Mitchell, who was Illinois Director of Finance when these publications were issued (but who recently resigned to become Vice President of the Federal Reserve Bank in Chicago) has—no doubt with considerable assistance from an able staff—made an important contribution through these volumes to more effective state budgeting and financial reporting.

ALLEN D. MANVEL

Washington, D. C.

Defense without Inflation. By ALBERT G. HART. New York: The Twentieth Century Fund, 1951. Pp. 186. \$2.00.

Financing Defense: Federal Tax and Expenditure Policies. By ALBERT G. HART and E. CARY BROWN, assisted by H. F. RASMUSSEN. New York: The Twentieth Century Fund, 1951. Pp. 161. \$2.00.

These volumes are the first two in a projected series of at least four studies of the major issues of economic policy in the emerging defense economy. The first volume presents an able over-all review of the goals and dangers of our current mobilization and the major alternatives of policy

for economic stabilization. The second volume concentrates on the federal budget, analyzing in much more detail the various tax and expenditure policies open to the government in its effort to finance the defense program in ways which will avoid serious inflation. Subsequent studies will be devoted to similarly detailed treatments of monetary and fiscal problems, and of direct controls.

Affirming our national policy of rapidly increasing military strength at home and among our allies to deter potential aggression if possible and to be ready to meet it if it comes, the first study emphasizes a policy of *readiness* which can be *sustained* for as long as may prove necessary. Sustained readiness over an extended period requires that economic efficiency and productivity—in civilian as well as in military lines—be maintained and increased if possible. Effective control of inflationary pressures is essential to the success of this policy. Granted that *some* price increases can be helpful in facilitating needed diversions of resources, "inflation does not stop with just these desirable increases . . ." but spreads in a cumulating "spiral (which) delays and thwarts the adjustments which have to be made"; it impairs productive efficiency, weakens work incentives, leads to bitter distrust and intergroup conflict within the nation, and undermines essential political processes.

A separate chapter examines the basic causes of inflation in terms of the "upward pull" on prices created by excessive demands on the one hand, and the "cost push" set up by upward pressures of wages and material prices on the other. Stressing the severity of these pressures during the "mobilization hump" and the necessity of adapting stabilization strategy to the inevitable uncertainties of the mobilization period, the study contains three brief chapters of some 20 or 25 pages on the usefulness and limitations of direct controls and fiscal and monetary measures for stabilization in this context. Basic differences be-

tween the present situation and conditions during the last war are emphasized with the conclusion that we must rely primarily on fiscal and monetary measures to achieve stabilization during the period of mobilization and "readiness." Direct controls, while necessary, tend to wear out; a readiness economy must not subject them to heavy strain too early or for too long; and the success of these controls in making their own important contributions depends essentially on fiscal and monetary measures which will keep the excess demands to be repressed within reasonably small magnitudes. While monetary policy has much to contribute, the strongest and most reliable tools of stabilization policy involve federal revenues and expenditures.

In effect, *Financing Defense* expands the 25 page chapter on tax and expenditure policy of the first volume into a full book. The fuller analysis and discussion is very much worth while. Diagnoses of the prospective general economic situation and budget position are brought up to date (mid-1951) in the first and second chapters, which also relate budget policy to other stabilization measures and examine the possibilities of substantial reductions in inflationary pressure through cuts in nonessential outlays. The authors find that "Most of the suggested economies are of a type that will not take hold immediately in reducing inflationary pressure, . . . While there is no reason for letting economy go by default, inflation can be controlled only by increased taxes. This harsh fact is one that must be faced by the American people and the Congress." (p. 35)

Professors Hart and Brown then examine the role of subsidies and tariffs in stabilization policy. Although these involve some exception to the rule that measures tending toward a larger deficit are inflationary because they reduce the "cost push," they nevertheless are likely to increase the "demand pull." Their role is consequently quite limited: "if the political log-rolling process of 'special privileges for everybody'

once sets to work on subsidies, it is plain we will need massive taxes to offset the income-increasing effects. This fact is easily overlooked . . . But if we rely on subsidies for anything more than adjustment at a few key spots to improve the 'consumption mix,' this budgetary requirement may presently grow to the point of paralysis." (p. 45)

The chapter on commodity taxes is especially strong. These are classified into "demand-shifters," "demand-absorbers," and general sales taxes. The economic characteristics of commodities adapted to each of the former two levies are lucidly developed, and the generally favorable incentive effects of the taxes are well explored in brief compass, as are the possibilities of personal exemptions to improve the equity of general excises. Despite the real strength of the chapter it appears that Professors Hart and Brown continue to differ in their judgments as to the effectiveness and desirability of general sales taxes, (especially p. 70) and probably to some extent also on the conclusion (p. 111) that if a broader tax than that now provided by the personal income tax is needed, lowering of exemptions is a better way of uncovering more tax potential than is a general sales tax.

These differences, of course, go to the heart of tax policy and readers will appreciate the penetrating discussion of just what the critical underlying judgments involve. In this connection, the reader's attention should be especially called to two important points not made in the body of the chapter. The first (p. 12) emphasizes the critical importance of excluding a sales tax from the official indexes used in computing wage and farm-price adjustments in order to eliminate the serious, undesirable cost-push effects such a levy would otherwise have; the other (p. 70) is the political consideration that enactment of a sales tax is likely to raise the *over-all* tax ceiling by making increases in other taxes acceptable when they otherwise would not be.

The chapter on the personal income tax

is notable for its emphasis on the as yet untapped revenue potential and the ideal flexibility of this tax in adapting the federal budget to uncertainty. It is estimated that stricter enforcement would add well over a billion dollars a year at an added administrative cost of less than \$10 million. Lowering exemptions by one third would yield over \$5 billion in revenue and probably have favorable incentive effects, but refundable taxes ("compulsory loans"), the spending tax, and other "new" personal taxes do not look very useful or desirable for the visible future.

The chapter on profits taxes is notable for its clear recognition of the limited role of these taxes in directly reducing spending by corporations and their stockholders bearing the tax. Considerable emphasis, on the other hand, is placed upon the *indirect* importance of high profits taxation as part of the master "stabilization compromise" since profits taxes presumably make it easier to get acceptance of necessary stabilization measures from other groups, notably labor unions and the farm bloc. But the authors recognize that even on this ground the case is not clean-cut. While high profits taxes make wage control more feasible, they also make it more necessary because they undermine employer resistance to wage increases. And while profits taxes should presumably be very high from the standpoint of contributing to the reciprocal willingness of other interest groups to make sacrifices, nevertheless from the standpoint of healthy business incentives, low rates are to be preferred. Similarly, excess profits taxes have popular appeal and are in keeping with the "congressional penchant for stiffening rates on small tax bases" but involve greater disincentives than income taxes yielding equal revenue.

The final chapter develops the authors' strategy in adapting the federal budget to uncertainty. While the discussion generally follows the lines of Professor Hart's earlier writings, their development in terms of the present situation is valuable. After once-

and-for-all increases in special excise and corporate income taxes, primary reliance for flexibility is placed upon personal income taxes, general sales and possibly payroll taxes. Congress would pass in advance a bill providing for a prescheduled series of step-ups in basic rates designed to maintain a moderate budget surplus on the basis of current estimates, but with executive discretion to postpone scheduled increases when there were "objective signs of a weakening of markets." The potentialities of the approach are challenging to say the least. It is to be hoped that they will receive even more detailed consideration than has yet been given.

Economics and economists have come a long way in the last decade or so. More and more economists have been recognizing their social responsibility to apply their analytical abilities and special insights to the hard facts of major policy issues. And they have been increasingly recognizing that their contribution depends not only on writing for each other but upon presenting the fruits of their analysis of realistic conditions in a form which will be useful to the lay public, to the member of Congress, and to the government administrator who among them in the final analysis determine what policy shall be. All too many alleged "popularizations" of difficult subjects and issues render a positive disservice because they leave out and distort what they attempt to simplify. These volumes do come to grips with the real issues, they do face up to the hard facts of the realistic situation, and they do make heartening and exemplary use of vigorous economic analysis; and they do all this with a lucidity, cogency, and reasonable brevity that are seldom matched. These volumes should be "must" reading for all who have responsibility for determining policy; they are exceptionally well adapted to classroom use; and they will justifiably command widespread professional interest.

JOHN LINTNER

Harvard University

Taxing Municipal Bond Income. By LYLE C. FITCH. Berkeley and Los Angeles: University of California Press, 1950. Pp. xi + 161. \$2.50.

In this little volume Mr. Fitch undertakes a big job of pointing a way to the elimination of tax exemption on outstanding and future issues of municipal bonds without jeopardizing the bondholders' investment in exemption or the borrowers' subsidy. Although conceding that a more efficient method could be devised to subsidize state and local governments, Mr. Fitch finds no clear case for abolishing the present subsidy. He is justly concerned, however, over the inequities created among taxpayers by this source of tax avoidance. He therefore presents a "model" plan (with alternatives) which would eliminate such tax benefits to holders of outstanding securities, future buyers of outstanding bonds, and buyers of future new and refunding issues, without increasing the cost of state and local borrowing.

The plan to tax outstanding issues protects the bondholders' investment in exemption by a tax credit equal to the difference in interest actually received and what would have been received on a comparable taxable issue, which would be applied against a tax on the interest from the municipal issue *plus* the interest differential. The interest presumed to be obtainable on a comparable security would be determined by reference to the bond interest differential at the time of purchase. In order to protect present bondholders against "undue" capital losses the need is recognized of providing a similar credit for future purchasers. The plan provides for compensating states and municipalities for their loss of tax exemption on future issues by a direct federal subsidy related to their cost of borrowing. In addition, they would be entitled to tax outstanding and future issues of federal securities.

Mr. Fitch's estimation of the average annual yield differential appears to measure the investment in exemption with tolerable

accuracy. For the purpose in mind, however, account would have to be taken of significant fluctuations in yield within some years. The discussion of factors influencing the yield differential is fairly comprehensive but not definitive. In view of the dominant position of commercial banks in the market for tax-exempt securities the role of the corporation tax rate warrants more attention than it is given. Although the supply of federal partially tax-exempt bonds is mentioned as an important factor influencing historical changes in the yield differential, the supply of wholly tax-exempt federal securities and federal farm loan bonds appears to be ignored. Nor is there any suggestion of the value attached to exemption from state and local taxes.

Mr. Fitch has made a valuable contribution to the literature in this field by his systematic and well integrated analysis. But the logical development of his thesis is not apt to have much, if any, appeal to state and local governments. The unfavorable reaction to the recent revival of the tax exemption issue in Congress is eloquent testimony to the belief of state and local governments in the sanctity of their "right" to immunity from federal "control" in this respect. Moreover, adoption of Mr. Fitch's proposal would place the Federal Government in the awkward position of underwriting directly many bond issues with a dubious claim to tax exemption.

It is little realized that the repeal of tax exemption on future issues would ultimately increase aggregate state and local budgets by probably less than one per cent. Not only would the privilege of taxing federal bonds largely offset this increased cost (although resulting in somewhat different distribution) but the net increase in revenues to the Federal Government would also better permit direct grants to communities for schools, roads, and other public improvements which are based on need instead of the present inefficient interest subsidy.

GEORGE E. LENT

Washington, D. C.

Tax Structure of the State of Washington.

By MAURICE W. LEE. Pullman, Washington: School of Economics and Business, State College of Washington, 1950. Pp. 142. Paperbound edition, 50 cents; clothbound, \$2.50.

The purpose of this book is not to advocate any particular tax program but rather to inform the citizens of the state on one of Washington's most pressing problems, its tax structure and the difficulties of increasing revenues to match government expenditures. The state government now relies primarily upon a retail sales tax. At a 3 per cent rate with no exemption of food purchases, Washington imposes the highest per capita sales tax of any of the states. The property tax is of course the bulwark of local government finance, and it is shown to rest upon an erratic pattern of valuations which falls far short of constitutional requirements. Together these two taxes provided almost 60 per cent of state and local tax collections in Washington in 1948. Most of the remainder came from other excises.

Income taxation is thus conspicuously absent. Legislative bills which would have enacted a progressive income tax in the thirties were judged unconstitutional on two occasions, and the author gives considerable attention to this problem.

Tax Savings in Real Estate Transactions.

By BUREAU OF ANALYSIS, Davenport, Iowa, under Auspices of National Institute of Real Estate Brokers of the National Association of Real Estate Boards. Davenport, Iowa: Bureau of Analysis, 1951. Pp. x+98. \$5.00.

This volume deals with the application of federal income tax laws to real estate transactions. It includes chapters on sales, purchases, exchanges, leases, and defaulted mortgages. Relevant provisions of the law are summarized and illustrated under a large number of topical headings.

Texas Property Taxes, 1949. By LYNN F. ANDERSON. Austin: Institute of Public Affairs, University of Texas, 1950. Public Affairs Series No. 3. Pp. 127. \$2.00.

This study presents in tabular form information on assessed valuations and nominal and "adjusted" tax rates in the counties, cities, and school districts of the State of Texas. Also included is a tabulation of overlapping property tax rates in cities. The adjusted tax rates were computed by multiplying nominal tax rates by local officials' estimates of the ratio of assessed to market value. Despite the customary requirement that all property be assessed uniformly at its full market value, wide variations in county assessing practices in 1949 resulted in an estimated range of the state adjusted tax rate (nominally 72 cents) from a low of 6 cents to a high of 72 cents per \$100 and an average of 29 cents.

The author includes a 13 page textual summary and interpretation of the statistical data.

Assessment Administration: 1950. Papers Presented at the Sixteenth International Conference on Assessment Administration, Held at Atlantic City, New Jersey, October 9-12, 1950. Chicago: National Association of Assessing Officers, 1950. Pp. 214. \$5.00.

This volume includes papers on construction costs, reassessment problems, assessment ratios, household furnishings, rural assessments, state supervision, building classification, intangibles, tangible personal property, and state assessment problems.

A leaflet listing *Census Bureau Publications on Governments* has been issued by the Bureau of the Census and is available from that agency upon request. This bulletin describes briefly each of the 14 reports on governmental finances and employment which the Census Bureau expects to issue in the fiscal year beginning July 1, 1951, and lists other recent publications of the Bureau regarding state and local governments.

NTA NOTES

NEW MEMBERS

CALIFORNIA

MR. E. J. LAGE, Asst. Manager
Tax Dept., Pacific Gas & Electric Co.
245 Market Street, San Francisco
LOS ANGELES STATE COLLEGE LIBRARY
855 North Vermont Avenue
Los Angeles 27

DELAWARE

MR. HARRY J. MACK, C.P.A.
Mack and Company
606 Equitable Building, Wilmington

GEORGIA

MR. WILLIAM M. LESTER
Deputy State Revenue Commissioner
517 State Office Building, Atlanta 3

ILLINOIS

MR. WALTER S. MAKER, Atty.
Law Dept., Armour and Company
Union Stock Yards, Chicago 9
MR. RALPH J. WEHLING, Atty.
Law Dept., Armour and Company
Union Stock Yards, Chicago 9

MARYLAND

MR. DOUGLAS H. ELDRIDGE, Economist
7604 Aberdeen Place, Bethesda 14

MINNESOTA

MR. HUGH H. HITE, Vice-Pres.
Minneapolis Gas Co.
739 Marquette Ave., Minneapolis 2
MR. JAMES R. G. OLSON, Instructor
School of Business Administration
University of Minnesota, Minneapolis 14

NEW JERSEY

MR. HENRY ROESER, JR., C.P.A.
Henry Roeser & Co.
Box 333, Ocean City

NEW MEXICO

MR. CHARLES H. CORLETT
Commissioner of Revenue
State of New Mexico
State Capitol, Santa Fe

NEW YORK

MR. JOSEPH L. BORDA
Room 804
14 West 49th Street, New York 20

OKLAHOMA

MR. F. B. PLANK, Vice-Pres. & Secy.
Cities Service Oil Co.
Masonic Building, Bartlesville

PENNSYLVANIA

MR. W. CHAS. BUTSCHER
Mathieson, Aitken & Co.
11th Floor
112 South 16th Street, Philadelphia 2

MR. ROBERT CALDWELL, JR., C.P.A.
Charles S. Rockey & Co.
1315 Walnut Street, Philadelphia 7

MR. ROWLAND CARR, C.P.A.
507-8-9 Dime Building, Allentown

MR. EDWARD A. COUGHLAN, C.P.A.
123 South Broad Street, Philadelphia 9

MR. J. S. COWING, Partner
Main and Co.
2222 Packard Building, Philadelphia 2

MR. ROBERT G. DRESLIN, C.P.A.
Robert G. Dreslin and Co.
303 Norristown-Penn Trust Building,
Norristown

MR. JOSEPH H. HECHT, C.P.A.
Ernst & Ernst
1235 Broad Street, Philadelphia 9

MR. F. WILLARD HEINTZELMAN, C.P.A.
4026 Payton Road, Drexel Hill

MR. JAMES A. MCQUAIL, JR., C.P.A.
John Heinst Co.
1421 Chestnut Street, Philadelphia 2

MR. JAMES J. MAHON, JR., C.P.A.
Lybrand, Ross Bros. & Montgomery
2101 Packard Building, Philadelphia 2

MR. CHARLES J. ROWLAND, C.P.A.
Dill & Rowland
12 Glennland Building, State College

MR. F. M. SPEAKMAN, C.P.A.
456 Bourse Building, Philadelphia 6

MR. JOHN T. STAPLETON, C.P.A.
John T. Stapleton & Co.
Deposit and Savings Bank Building
Wilkes Barre

TEXAS

MR. JOHN R. ABBOTT, Evaluation Engineer
Pritchard & Abbott
504 Century Building, Fort Worth 2

MR. J. C. ADERHOLTZ
Tax Assessor and Collector
City of Grand Prairie
P.O. Box 387, Grand Prairie

MR. GEORGE L. BENNETT
Tax Assessor-Collector
Goose Creek Independent School District
P.O. Drawer 30, Baytown

MR. ROBERT BOWER
Tax Dept., Gulf Oil Corporation
P.O. Drawer 2100, Houston 1

MR. LESLIE G. CARRUTH
Ad Valorem Tax Consultant
L. R. Carter
412 Reserve Loan Life Building, Dallas 1

MR. L. R. CARTER, Ad Valorem Tax Consultant
412 Reserve Loan Life Building, Dallas 1

MR. WEBB B. COOLEY, Manager
Ad Valorem Tax Dept.
Magnolia Petroleum Company
Box 900, Dallas 1

MR. C. F. ELLISON, JR., Ass't. Secy. & Treas.
Houston Lighting & Power Co.
P.O. Box 1700, Houston

MR. MURRY H. FLY, President
Odessa College
Box 3752, Odessa

MR. I. G. GASSER, Tax Supervisor
P.O. Box 478, Dallas 1

MR. NEAL E. HAVENS, Tax Agent
Magnolia Petroleum Company
Box 900, Dallas 1

MR. GERALD F. HOOPER, Landman
George H. Coates
638 Milam Building, San Antonio

MR. W. A. IRWIN, Accountant
George H. Coates
638 Milam Building, San Antonio

MR. R. DRUMWRIGHT KEYS, C.P.A.
2707 Mockingbird Lane, Dallas

MR. D. E. KINNAMON
The Atlantic Refining Co.
Box 2819, Dallas

MR. WILLIAM B. KLINE, Tax Representative
Southwestern Bell Telephone Company
1205 Telephone Building, Dallas

MR. MARVIN E. MCCORD, Tax Assistant
Southwestern Bell Telephone Company
1205 Telephone Building, Dallas

MR. VICTOR J. MANDEVILLE, Tax Agent
Southwestern Bell Telephone Company
1205 Telephone Building, Dallas

PROFESSOR EDMUND T. MILLER
910 Poplar Avenue, Austin

MR. CURTIS MORRIS, Vice-Pres.
Transcontinental Gas Pipe Line Corp.
3100 Travis Street, Houston 6

MR. JAMES T. OGG
Superintendent of Schools
Pine Tree Independent School District, Greggton

MR. A. F. PAGE, JR.
Tax Dept., Gulf Oil Corporation
P.O. Drawer 2100, Houston 1

MR. JOE L. PANGLE, Tax Representative
Southwestern Bell Telephone Company
1205 Telephone Building, Dallas

MR. SIDNEY B. PETRIE, Secy.-Controller
Delhi Oil Corporation
1315 Pacific Ave., Dallas

MR. E. S. PRITCHARD, Evaluation Engineer
Pritchard & Abbott
504 Century Building, Fort Worth 2

MR. GEORGE PROWSE, County Judge
Nueces County
County Courthouse, Corpus Christi

MR. W. H. SPARKS, Head
Land Dept., General American Oil Co. of Texas
1406 Republic Bank Building, Dallas

MR. PAT F. TIMMONS, Tax Counsel
Transcontinental Gas Pipe Line Corp.
3100 Travis Street, Houston 6

MR. J. EUGENE TRICE
Mid-Valley Pipeline Co.
P.O. Box 2388, Longview

MR. F. D. WARD, Asst. Tax Comr.
Gulf Refining Co.
P.O. Drawer 2100, Houston

MR. DAN G. WEBSTER, JR., Manager
Property, Tax & Insurance Dept.
Continental Supply Co.
P.O. Box 359, Dallas 1

MR. R. F. WILLIAMS
Tax Dept., Gulf Oil Corporation
P.O. Drawer 2100, Houston 1

HAWAII

MR. JOHN A. BAKER, JR., C.P.A.
Baker & Gillette
Hawaiian Trust Building, Honolulu 13

JAPAN

DR. HANYA ITO
520 Kichijoji
Musashino City, Tokyo

MR. HIROSHI YOSHISE
1616 Higashiterao
Tsurumi-Ku, Yokohama

STATEMENT OF THE OWNERSHIP, MANAGEMENT,
CIRCULATION, ETC., REQUIRED BY THE ACT
OF CONGRESS OF AUGUST 24, 1912, AS
AMENDED BY THE ACTS OF MARCH
3, 1933, AND JULY 2, 1946

Of *National Tax Journal*, published quarterly at
Lancaster, Pennsylvania, for October 1, 1951.

STATE OF CALIFORNIA }
COUNTY OF SACRAMENTO } ss:

Before me, a Notary Public in and for the State and county aforesaid, personally appeared Ronald B. Welch, who, having been duly sworn according to law, deposes and says that he is the Business Manager of the *National Tax Journal* and that the following is, to the best of his knowledge and belief, a true statement of the ownership, management, etc., of the aforesaid publication for the date shown in the above caption, required by the Act of August 24, 1912, as amended by the Acts of March 3, 1933, and July 2, 1946 (section 537, Postal Laws and Regulations), to wit:

1. That the names and addresses of the publisher, editor, managing editor, and business manager are:

Publisher—National Tax Association, P.O. Box 1799, Sacramento 8, California.

Editor—J. Keith Butters, Soldiers Field, Boston 63, Massachusetts.

Managing Editor—None.

Business Manager—Ronald B. Welch, P.O. Box 1799, Sacramento 8, California.

2. That the owner is: National Tax Association, a non-stock corporation, chartered in the District of Columbia, whose principal office is located at 1020 N Street, Sacramento 14, California.

3. That the known bondholders, mortgagees, and other security holders owning or holding 1 per cent or more of total amount of bonds, mortgages, or other securities are: None.

(Signed) RONALD B. WELCH, *Business Manager*.

Sworn to and subscribed before me
this 8th day of October, 1951.

(Signed) Bess L. Bieser,

Notary Public, County of Sacramento,
State of California.

Commission expires January 17, 1954.

P.O. Box

oston 63,

P.O. Box

ciation, a
istrict of
: 1020 N

gees, and
per cent
gages, or

anager.

NATIONAL TAX ASSOCIATION

Organized 1907 — Incorporated 1930

OBJECT. The National Tax Association is a non-political, non-sectarian, and non-profit-making educational organization. Its object, as stated in its certificate of incorporation, is to educate and benefit its members and others by promoting the scientific study of taxation and public finance; by encouraging research; by collecting, preserving, and diffusing scientific information; by organizing conferences; by appointing committees for the investigation of special problems; by formulating and announcing, through the deliberately expressed opinion of its conferences, the best informed thought and ripest administrative experience available for the guidance of public opinion, legislation, and administration; and by promoting better understanding of the common interests of national, state, and local governments in the United States and elsewhere, in matters of taxation and public finance and interstate and international comity in taxation.

MEMBERSHIPS. The Association welcomes to its membership, for mutual discussion and deliberation, all who may be interested in taxation and public finance generally. Annual dues are: junior memberships (for individuals under thirty-five years of age), \$5; senior memberships (for other individuals and organizations), \$10; sustaining memberships, \$100.

PUBLICATIONS. The NATIONAL TAX JOURNAL is published quarterly in March, June, September, and December. PROCEEDINGS of the annual conferences on taxation which are sponsored by the Association are published soon after the meetings. The JOURNAL and the PROCEEDINGS are sent to members without charge. To non-members the price of the JOURNAL is \$3.75 per year, single numbers, \$1.25. The prices of the PROCEEDINGS vary; that of the 1950 volume is \$6.75.

Applications for membership, orders for publications, and general inquiries should be addressed to Ronald B. Welch, Secretary, National Tax Association, P.O. Box 1799, Sacramento 8, California.

OFFICERS

WILLIAM A. SUTHERLAND, Attorney, Washington and Atlanta, *President*
ALFRED G. BUEHLER, University of Pennsylvania, *Vice President*
RONALD B. WELCH, State Board of Equalization, California, *Secretary*
ROBERT J. EBY, New Rochelle, N. Y., *Treasurer*

EXECUTIVE COMMITTEE

The above officers ex-officio, the three ex-presidents who have last held office, and nine elected members

Elected Members

ROBERT S. FORD, University of Michigan
C. EMORY GLANDER, Tax Commissioner of Ohio
JOHN F. HEALY, Colorado Department of Revenue
MORTIMER M. KASSELL, Deputy Commissioner of Taxation and Finance, State of New York
I. M. LABOVITZ, U. S. Bureau of the Budget
LEO MATTERS-DORF, C.P.A., New York
H. CLYDE REEVES, Commissioner of Revenue, Commonwealth of Kentucky
J. L. REUTHER, Southwestern Bell Telephone Co., St. Louis
C. L. TURNER, C.P.A., Philadelphia

Ex-Presidents

GEORGE W. MITCHELL, Director of Finance, Illinois
CARL SHOUP, Columbia University
G. HOWARD SPARTH, Commissioner of Taxation, Minnesota

Honorary Members

A. KENNETH EATON, Department of Finance, Dominion of Canada
PHILIP T. CLARK, Controller of Revenue, Province of Ontario

ian,
its
by
ing
by
pe-
er-
is-
and
ests
in
ity

for
nd
als
als

riy
n-
on
ers
ar,
50

ise
n,

als
n,

ee